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VOL. IX MAY, 1937 No. 4

THE SOCIAL SECURITY ACT AND FREE JUDICIAL CHOICE

*Thomas A. Cowan**

INTRODUCTION

When Francois Geny wrote his celebrated treatise entitled *Science et technique en droit prive positif*,[1] he pointed out how much latitude judges have for the exercise of what he called "free scientific research" even in so detailed a system of law as the French Civil Code. If no applicable section of the Code exists, or if pertinent sections are ambiguous, the judge is free to decide the case in accordance with his own ideas as to what the law ought to be. So, too, where equity or reasonable conduct is involved, judicial choice necessarily exists.

If this condition be true with respect to a comprehensive code, how much more is it the case with the Constitution of the United States which, aside from those sections that provide for the framework of the federal government, is merely a statement of general principles for the guidance of governmental action. Little positive legislation is contained in the Constitution. The powers of the legislature, the executive, and the judiciary are conferred in terms that invite interpretation, and require constant re-examination. For example, Congress may tax to pay debts and to provide for the common defense and the general welfare of the nation. It has power to regulate commerce between the states and with foreign nations. The President is charged with the general duty of seeing that the laws are executed. The federal courts have jurisdiction over all cases and controversies involving the Constitution, treaties, and laws of the United States.

Constitutional limitations are likewise imposed in terms of vague and general import. No state shall pass any law impairing

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The author wishes to acknowledge with thanks the assistance given to him by his associate, Samuel Edes, Esq., in the preparation of this article.

[1]Vol. 1, 1913; vol. 2, 1915; vol. 3, 1921; vol. 4, 1924.

the obligation of contracts. Freedom of speech and of the press may not be abridged. Life, liberty and property may not be taken without due process of law.

It is not contended here that broad powers of government have been conferred upon the United States by the terms of the Constitution. Our interest is not at this time in the question of a wide as opposed to a narrow construction of the powers of the federal government. We merely wish to emphasize the fact that powers have been conferred and limitations imposed on the government of the United States in terms that are not self-explanatory.[2] Whatever one's view of the sum total of governmental power conferred by the Constitution, such power must be interpreted and general principles must be given meaning before we can speak of a Constitution at all.

Within the limits of admittedly legitimate constitutional powers, Congress is free to exercise its legislative will as it chooses, the objects of possible congressional legislation being manifold.[3] The president may execute the laws by any means that recommend themselves to him, so long as constitutional guarantees are observed, and legislative mandates complied with. Is it not also true then that to the extent that the federal courts have jurisdiction, they too may interpret the Constitution as they see fit? Not exactly. Courts are restricted by the self-imposed limitations of the legal craft. Precedent binds them peculiarly, whereas it affects Congress and the president no more than it does the generality of mankind. Traditional technique keeps courts in line, and an elaborate system of judicial etiquette dictates much of what they do. This last is well known. In fact it is so well known that it seems to many to be the very essence of the judicial process. Such a view assigns to the judge the role of an expert giving a scientific opinion of the

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[2]This was appreciated, at least in part, by Mr. Chief Justice Marshall when he stated in Gibbons v. Ogden, 9 Wheat. 1, 189 (1824): "The subject to be regulated is commerce; and our Constitution being . . . one of enumeration, and not of definition, to ascertain the extent of the power it becomes necessary to settle the meaning of the word."

[3]This has been stated over and over again in numerous cases. License Tax Cases, 5 Wall. 462, 469 (1866); Champion v. Ames, 188 U. S. 321 (1903). In answering the contention that the National Labor Relations Act was one-sided in its application and that it fails to provide a more comprehensive plan for the regulation of labor relations, Mr. Chief Justice Hughes pointed out that "we are dealing with the powers of Congress, not with a particular policy or with the extent to which policy should go. We have frequently stated that the legislative authority, exerted within its proper field, need not embrace all the evils within its reach. The question . . . is whether the legislature, in what it does prescribe, has gone beyond Constitutional limits." National Labor Relations Board v. Jones & Laughlin Steel Corp., No. 419, Oct. Term, 1936, decided April 12, 1937. See also West Coast Hotel Co. v. Parrish, 57 Sup. Ct. 578, 583, 585 (1937); Nebbia v. New York, 291 U. S. 502, 537, 538 (1934).

meaning of words—an opinion at once disinterested and binding.[4] That the judiciary takes, and must necessarily take, an active and vital part in the constitutional process seems an alien idea. And yet how can it do otherwise when the language of the Constitution lends itself to so many variable and inapposite meanings?

Each of the three co-ordinate branches of the government is charged with the duty of obeying constitutional mandates, and each of them must interpret the Constitution for itself before engaging in most of its governmental activity. Constitutional practice is moulded by each branch of the government. Congress has developed a very elaborate code governing its own conduct.[5] And its legislation over a period of 150 years determines its own idea of its power under the Constitution. Of the tens of thousands of federal statutes enacted since the foundation of the government, fewer than seventy have been set aside by the Supreme Court. Executive practice also, while dependent to a certain extent upon Congress, has had an independent growth. And the federal courts have moulded constitutional authority by countless decisions, the vast majority of them putting the seal of approval upon legislative and executive action; a comparative few setting such action aside.

A nice instance of independent determination of constitutionality by the three branches of government existed in the case of the Webb-Kenyon Act[6] making it unlawful to ship intoxicating liquors into any state in violation of the laws of that state. This act originated in the Senate and was passed by both Houses of Congress. However, exercising his independent judgment as to its constitutionality, President Taft vetoed the bill.[7] Congress adhered to its original opinion and the bill was passed over the presidential veto. Finally the act withstood the ultimate test of con-

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[4]The jurisprudential literature on the judicial process as a mechanical art is plentiful. GNAEUS FLAVIUS (KANTOROWICZ), DER KAMPF UM DIE RECHTSWISSENSCHAFT 7; IHERING, DER ZWECK IM RECHT (1878); 2 BEROLZHEIMER, SYSTEM DER RECHTS UND WIRTHSCHAFTSPHILOSOPHIE § 44 (World's Legal Philisophies 351-374); KORKUNOV, GENERAL THEORY OF LAW (Hastings' trans.) 265-266; Pound, *Mechanical Jurisprudence* (1908) 8 COL. L. REV. 605; Pound, *Theory of Judicial Decision* (1923) 36 HARV. L. REV. 641, 802, 940; Vander Eycken, *Methode de l'interpretation juridique* (1907); ADAMS, CENTRALIZATION AND THE LAW (1906); 1 DOMAT, THE CIVIL LAW IN ITS NATURAL ORDER (Stranahan's trans. 1737) XXXIV *et seq.*; ABBOTT, JUSTICE AND THE MODERN LAW (1913).

[5]Vols. 1-5 HIND, PRECEDENTS OF THE HOUSE OF REPRESENTATIVES (1907); Vols. 6-8 CANNON, PRECEDENTS OF THE HOUSE OF REPRESENTATIVES (1936).

[6]Act of March 1, 1913, c. 90, 37 STAT. 699, 27 U. S. C. A. § 122.

[7]Message to the 63d Cong., 1st Sess., wherein the President, reviewing all of the pertinent cases, stated: "After giving the proposed enactment full consideration, I believe it to be a violation of the interstate commerce clause . . . in that it is . . . a delegation by Congress to the states of the power of regulating interstate commerce in liquors which is vested exclusively in Congress." SEN. DOC., 63d Cong., 1st Sess. 103.

stitutionality by a judgment of the Supreme Court of the United States in *Clark Distilling Co. v. Western Maryland R. R.*[8]

In passing upon the constitutionality of legislative and executive action the courts are performing a positive act of government, and in this field, precedent, the mainstay of the Anglo-American judicial process, is of little benefit to them. In the first place statutes are usually addressed to subject matters not already covered by legislation. Hence, for this reason alone past cases are likely to be inapplicable.[9] Secondly, legislation is deliberately framed to avoid decisions likely to serve as invalidating precedents.[10] Constitutional cases, particularly those setting legislation aside, are danger signs which loom large in the consciousness of legislative draftsmen. Therefore, one constitutional case "on all fours" with another is exceedingly rare.[11] In constitutional law, *stare decisis* is reduced to analogy.[12]

One hundred and fifty years of continuous activity in interpreting a relatively few clauses of an extremely short constitutional document has furnished the Supreme Court with abundant sets of precedents, many of which are saved from rank inconsistency only because a different form of words is used to formulate the principles for which they stand. To cite only a few, we have the following sets of contradictory rules of constitutional construction. Great weight must be attached to continuous Congressional constitutional practice,[13] but Congressional practice of however long

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[8]242 U. S. 311 (1917).

[9]See Champion v. Ames, 188 U. S. 321 (1903).

[10]A recent example of this was the revised Frazier-Lehmke Act, Aug. 28, 1935, c. 792, 49 STAT. 943-945, 11 U. S. C. A. § 3203 (s), designed to avoid the features of the former act declared unconstitutional in Louisville Joint Stock Land Bank v. Radford, 295 U. S. 555 (1935). The revised act was recently held constitutional in Wright v. Vinton Branch of Mountain Trust Bank, 57 Sup. Ct. 556 (1937).

[11]One such case was West Coast Hotel Co. v. Parrish, 57 Sup. Ct. 578 (1937), overruling Adkins v. Childrens' Hospital, 261 U. S. 525 (1923). Other cases that may be cited are: Legal Tender Cases, 12 Wall. 457, 553 (1870), overruling Hepburn v. Griswold, 8 Wall. 603 (1869); Morgan v. U. S., 113 U. S. 476, 496 (1884), overruling Pierce v. New Hampshire, 5 How. 504 (1847). A fairly complete enumeration is contained in a footnote by Mr. Justice Brandeis in Washington v. Dawson, 264 U. S. 219 (1923) and in Burnet v. Coronado Oil & Gas Co., 285 U. S. 393 (1932).

[12]This is exceedingly well illustrated in the Gold Clause cases. Norman v. B. & O. R. R., 294 U. S. 240 (1934); Nortz v. U. S., 294 U. S. 317 (1934); Perry v. U. S., 294 U. S. 330 (1934).

[13]Stuart v. Laird, 1 Cranch 299, 309 (1891); Martin v. Hunter, 1 Wheat. 304, 351 (1816); McCulloch v. Maryland, 4 Wheat. 316, 401 (1819); Cohen v. Virginia, 6 Wheat. 264, 420 (1821); Prigg v. Pennsylvania, 16 Pet. 544, 621 (1842); Cooley v. Port Wardens, 12 How. 299, 315 (1851); Burrows-Oils Lithographic Co. v. Sarmy, 111 U. S. 53, 57 (1883); Ames v. Kansas, 111 U. S. 449, 463 (1883); The Laura, 114 U. S. 411, 416 (1884); Wisconsin v. Pelican Ins. Co., 127 U. S. 265, 297 (1887); Field v. Clark, 143 U. S. 649, 691 (1891); McPherson v. Blackner, 146 U. S. 1, 28 (1892); Knowlton v. Moore,

continuance cannot create power where none is conferred by the Constitution;[14] the states may not burden interstate commerce,[15] but reasonable regulation of interstate commerce by the states is not unlawful;[16] Congress may not regulate in the guise of taxation,[17] but regulation incidental to the power to tax is lawful.[18]

When is a tax not a tax? When it is a regulation. When is a regulation not a regulation? When it is a tax? Is title IX of the Social Security Act constitutional? The answer involves a free choice between two competing lines of precedents, one setting tax statutes aside as unwarranted regulation and the other sustaining regulation as incidental to the power of Congress to tax.

The Litigation

On March 2, 1937, the Chas. C. Steward Machinery Company paid under protest to the United States Collector of Revenue for the District of Alabama the sum of $46.14. This amount had been assessed and collected under Title IX of the Social Security Act.[19] On the same day the taxpayer filed a claim for refund on the ground that the tax was an unconstitutional levy. On March 9 the claim for refund was denied and on March 10 the taxpayer commenced suit in the District Court of the United States for the Northern

---

178 U. S. 41, 56 (1899); United States v. Midwest Oil Co., 236 U. S. 459, 472 (1914); *Ex Parte* Grossman, 267 U. S. 87 (1924); Myers v. United States, 272 U. S. 52 (1926).

[14]Pollock v. Farmers' Loan & Trust Co., 158 U. S. 601 (1894); United States v. McDaniel, 7 Pet. 1, 14 (1833); United States v. Dickson, 15 Pet. 141 (1853); Greeley v. Thompson, 10 How. 225 (1850); United States v. Graham, 110 U. S. 219, 221 (1883); United States v. Tanner, 147 U. S. 661, 663 (1892); United States v. Alger, 152 U. S. 384, 397 (1893); see Swift Co. v. United States, 105 U. S. 691, 695 (1881). For a discussion of the various lines of cases see Fairbank v. United States, 181 U. S. 283, 308 (1900) *et seq.*

[15]Western Union Telegraph Co. v. Brown, 236 U. S. 542 (1914); Illinois Cen. R. R. v. Illinois, 163 U. S. 142 (1895); Hall v. De Cuir, 95 U. S. 485 (1877); McNeill v. Sou. R. R., 202 U. S. 543 (1905); South Covington R. R. v. Covington, 235 U. S. 537 (1914); St. Louis & S. F. R. R. v. Missouri, 254 U. S. 535 (1920).

[16]Hennington v. Georgia, 163 U. S. 299 (1896); Missouri Pac. R. R. v. Larabee Flour Mills Co., 211 U. S. 612 (1909); Gibbons v. Ogden, 9 Wheat. 1 (1824); Morgan's L. & T. R. R. v. La. Board of Health, 118 U. S. 455 (1886); Chicago, R. I. & P. R. R. v. Arkansas, 219 U. S. 453 (1911).

[17]Bailey v. Drexel Furniture Co., 259 U. S. 20 (1922); Hill v. Wallace, 259 U. S. 44 (1922); United States v. Constantine, 296 U. S. 287 (1934); United States v. Butler, 297 U. S. 1 (1935); Carter v. Carter Coal Co., 298 U. S. 238 (1936).

[18]Veazie Bank v. Fenno, 8 Wall. 533 (1869); Head Money Cases, 112 U. S. 580 (1884); McCray v. United States, 195 U. S. 27 (1904); United States v. Jin Fuey Muy, 241 U. S. 394 (1916); United States v. Doremus, 249 U. S. 86 (1919); United States v. Dougherty, 269 U. S. 360 (1925); Nigro v. United States, 276 U. S. 332 (1928); Hampton v. United States, 276 U. S. 394 (1928).

[19]Act of Aug. 14, 1935, c. 531, 49 Stat. 620, 29 U. S. C. A. § 456, 42 U. S. C. A. § 301 *et seq.*

District of Alabama. The Government at once demurred to the petition. On March 11 the court issued an order sustaining the demurrer and dismissing the cause.[20] That very day a petition for appeal was filed together with assignment of errors, order allowing appeal, bond, *praecipe*, and clerk's certificate. The case was set down for immediate trial in the Circuit Court of Appeals for the Fifth Circuit. Oral argument was eschewed. The taxpayer submitted its case on a brief filed in a prior suit in the same court[21] attacking the constitutionality of Title IX and the Government relied on its brief in the case of *Davis v. The Boston and Maine R. R.* recently decided in its favor by the District Court of the United States for the District of Massachusetts.[22] On March 20 the Circuit Court of Appeals affirmed the decision sustaining the demurrer,[23] and on March 29 the Supreme Court of the United States granted *certiorari* and set the case for hearing about April 5.[24]

The expedition with which this case reached the Supreme Court seems to justify the conclusion that it is not procedure but participants that account for much judicial delay. Much of the objection to having the Supreme Court pass upon the constitutionality of statutes rests in the fact that at times years elapse before a case is properly presented to the Supreme Court for its decision on constitutionality.[25] With good will on both sides and a judicial selection of a case which will properly raise the constitutional issue, delay in such matters may often be obviated. Certainly the Supreme Court has been especially cooperative in advancing the hearing and disposition of litigation of an important public nature.

The taxpayer in the *Steward* case squarely raised the question of the constitutionality of Title IX of the Social Security Act. There was no claim that the tax collector had exceeded his authority under the statute. The sole ground for the suit for refund was that Title

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[20]The District Court did not write an opinion.

[21]Beeland Wholesale Co. v. Davis, 88 F. (2d) 447 (No. 8321 C. C. A. 5th, 1937). On the authority of its decision in the Beeland case, the Court affirmed the decision of the District Court for the Southern District of Mississippi, which had upheld the validity of the Mississippi Unemployment Compensation Act of March 23, 1936, as amended Sept. 19, 1936. Miss. Laws 1936, c. 176, as amended by Miss. Laws Ex. Sess. 1936, c. 3. Aponang Mfg. Co. v. Fly, No. 8392, C. C. A. 5th, March 6, 1937. *Certiorari* being denied by the Supreme Court in the Beeland case, it was not applied for in the Aponang case.

[22]17 F. Supp. 97 (Mass. 1936), *cert. denied* Jan. 4, 1937.

[23]No. 8410, C. C. A. 5th, not yet reported.

[24]No. 837, Oct. Term, 1936. The case was argued on April 5, 1937.

[25]A recent example of this is the attack on the constitutionality of the Public Works program. This litigation has been in the courts since 1934, was argued in the Supreme Court late in 1936, and was remanded to the District Court to rectify a procedural error. Duke Power Co. v. Greenwood County, 57 Sup. Ct. 202 (1936). Much of this delay was due to dilatory tactics. A decision on the matter involved in that case cannot be expected before the next term at the earliest.

IX of the Social Security Act was unconstitutional and void for the following reasons:[26]

(1) In purpose and effect the Act coerces the enactment by the States of unemployment compensation laws.

(2) It violates the Ninth and Tenth Amendments of the Constitution by setting up a federal system of unemployment compensation by controlling the administration of the State statutes and the moneys raised under them, thus intruding on the constitutional power and jurisdiction of the States.

(3) By the system so created the property of the employers is taken without just compensation for the benefit of an arbitrarily defined class.

(4) The taxes imposed under the Act are not for revenue to support the Government for constitutional purposes, but for the purpose of providing funds to support State administrations in matters beyond the province of the Congress to control.

(5) The Act violates Article I, Section 1 of the Constitution by investing legislative authority in the Social Security Board in its stated activities.

The Statute

The Social Security Act is an omnibus statute covering a wide range of subjects pertaining to social welfare. It is divided into ten separate titles, which, as Judge Sibley remarked in *Steward Machine Company v. Davis,* "might have been made separate Acts."[27] Title I relates to Grants to States for Old Age Assistance. Title II covers Federal Old Age Benefits, a system of Federal pensions to superannuated workers. Title III authorizes an appropriation to cover grants to the states for the purpose of assisting them in the administration of their unemployment compensation laws. Titles IV, V, VI, and X provide for grants to states for aid to Dependent children, for Maternal and Child Welfare for Public Health, and for aid to the Blind, respectively; Title VII establishes the Social Security Board. Title VIII levies a tax on both employers and employees, presumably for workers' pensions. These taxes are not payable until 1938. Title IX lays a tax on every employer of eight or more persons with respect to having individuals in his employ, equal to certain percentages of the wages payable by him with respect to employment (as defined in the Section). This article is concerned only with Title IX of the Act.

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[26]See Brief for the Petitioner, Steward Machine Co. v. Davis, in the Supreme Court of the United States, No. 837, Oct. Term, 1936, *passim.*

[27]No. 8410, C. C. A. 5th, not yet reported.

Section 901 of the Act (the first Section of Title IX) lays the tax as just mentioned. Section 902 permits the taxpayer to credit against the federal tax an amount not to exceed 90 per centum of the contribution paid by him into an unemployment fund under a state law approved by the Social Security Board. Section 903 provides that the Social Security Board shall approve any such state law which provides:

> "(1) All compensation is to be paid through public employment offices in the State or such other agencies as the Board may approve;
>
> "(2) No compensation shall be payable with respect to any day of unemployment occurring within two years after the first day of the first period with respect to which contributions are required;
>
> "(3) All money received in the unemployment fund shall immediately upon such receipt be paid over to the Secretary of the Treasury to the credit of the Unemployment Trust Fund established by section 904;
>
> "(4) All money withdrawn from the Unemployment Trust Fund by the State agency shall be used solely in the payment of compensation, exclusive of expenses of administration;
>
> "(5) Compensation shall not be denied in such State to any otherwise eligible individual for refusing to accept new work under any of the following conditions: (A) If the position offered is vacant due directly to strike, lockout, or other labor dispute; (B) if the wages, hours, or other conditions of the work offered are substantially less favorable to the individual than those prevailing for similar work in the locality; (C) if as a condition of being employed the individual would be required to join a company union or to resign from or refrain from joining any bona fide labor organization;
>
> "(6) All the rights, privileges, or immunities conferred by such law or by acts done pursuant thereto shall exist subject to the power of the legislature to amend or repeal such law at any time."

Section 904 (a) establishes in the Treasury of the United States an "Unemployment Trust Fund" wherein are to be deposited all moneys received from state unemployment funds. The remaining subdivisions of the same section direct the manner in which these funds

shall be invested, and that upon requisition they shall be repaid to state agencies. Section 905 details regulations respecting collections, refunds, and penalties. Subdivision (a) of this section provides that "The tax imposed by this title shall be collected by the Bureau of Internal Revenue under the direction of the Secretary of the Treasury and shall be paid into the Treasury of the United States as internal-revenue collections." Section 908 permits the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, to make rules and regulations for the enforcement of this title. Sections 909 and 910 provide for additional credit against sums paid by the taxpayer before the date of filing his return, the total credit in any case, however, not to exceed 90 per centum of the tax.

We thus have what purports to be an excise tax on the privilege of employing persons, with a credit (up to 90 per centum of the tax) of all amounts paid under state unemployment compensation laws approved by the Social Security Board.

Constitutionality

The inevitable effect of Title IX is to induce states to enact unemployment insurance laws satisfying the rather simple conditions laid down by Congress. One would be extremely naive not to realize that this was the effect Congress sought to accomplish. The Act is a compromise, a measure half-way between genuine state administration and genuine federal administration of unemployment insurance. The federal government holds the funds. The states spend them under the general supervision of the federal government. Why this cumbersome and disingenuous scheme was resorted to instead of a straight federal plan of taxation is a mystery to many people, including the writer. In the face of the notoriously vaccilating conduct of the Supreme Court in accepting or rejecting regulation in the guise of a tax, it would seem that an ordinary federal excise tax the proceeds of which were covered into the general treasury would not have raised so serious a question of constitutionality and would have been infinitely preferable. If it were thought expedient to develop unemployment insurance plans along state lines,[28] the federal government could then make appropriate grants out of the general treasury to the states for this purpose. The effect of the straight excise tax on employers would take care of destructive competition between industries in states having unemployment plans and those in states without such plans.

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[28]Senator Wagner, 79 Cong. Rec. 9283, 9284. Appellant's Brief, p. 76, Beeland Wholesale Co. v. Davis, 88 F. (2d) 447 (No. 8321, C. C. A. 5th, 1937).

The tax would be purely a revenue measure.[29] The grants out of the general treasury could, in view of a great number of precedents,[30] more easily be justified, and in any event would be extremely difficult procedurally to attack.[31]

That the framers of Title IX sought to effect state enactment of unemployment insurance legislation seems inescapable. Credits on the federal tax are withheld until the states comply with the requirements of the Act. The following exchange between Senator Connally and Dr. Witte, a proponent of the bill is illuminating.

> Senator Connally: "Of course, it [the bill] is designed to coerce the states into coming in."
>
> Dr. Witte: "You can use that phrase if you want to."
>
> Senator Connally: "Whether you use the word 'induce' or 'coerce' the result is the same. The State says, 'Well, we are going to pay the 3 per cent tax anyway, or the Government is going to take it away from us, so we will pass it ourselves.' That is the philosophy of the bill?"
>
> Dr. Witte: "The philosophy of the bill is to make it possible for the states to act."[32]

The Precedents

From the point of view of legal analysis, the leading cases[33] on the power of Congress to regulate by an exercise of the tax power lead to nothing but confusion. No single criterion of a tax as opposed to a regulation is to be found in them. A brief description of these cases, followed by a detailed examination of them makes this point abundantly clear. The cases to be considered are the following:

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[29]To hold such a tax to be part of a scheme of regulation it would be necessary for the Court to extend its already novel doctrine expounded in United States v. Butler, 197 U. S. 1 (1935).

[30]The system of federal grants in aid began at the very inception of our government and has been sanctioned not only by long continued Congressional practice, but by the Supreme Court and by commentators as well. Chief Justice Marshall in McCulloch v. Maryland, 4 Wheat. 316, 401 (1819) stated: "The principle now contested was introduced at a very early period in our history, has been recognized by many successive legislatures, and has been acted upon by the judicial department, in cases of peculiar delicacy, as a law of undoubted obligation." See also Nashville, C. & St. L. Ry. v. Walters, 294 U. S. 405, 417 (1935); Digest of Legislation Providing Federal Subsidies for Education (U. S. Dept. of Interior, Office of Education) Bull. No. 8, pp. 3, 4 (1930); McDONALD, FEDERAL AID (1928) 43; Brief for Respondent, Duke Power Co. v. Greenwood County, 57 Sup. Ct. 202, 212 (1936).

[31]Frothingham v. Mellon, 262 U. S. 447 (1928).

[32]*Hearings before Committee on Finance of the Senate*, pp. 239, 241. Appellant's Brief, p. 125, Breeland Wholesale Co. v. Davis, 88 F. (2d) 447 (C. C. A. 5th, 1937).

[33]*Supra* notes 17, 18.

(1) *License Tax Cases*[34]—License tax upon those engaged in selling lottery tickets or liquor at retail. Defendants resisted the tax on the ground that the laws of their respective states forbade those activities and that hence Congress could not lawfully exact revenue from the commission of a crime. Held valid.

(2) *Veazie Bank v. Fenno*[35]—Ten per cent tax on circulating notes issued by state banks, held valid.

(3) *McCray v. United States*[36]—Ten per cent per pound tax on oleomargarine colored to resemble butter as opposed to one-quarter of one cent per pound tax on oleomargarine not so colored, held valid.

(4) *United States v. Doremus*[37]—Detailed rules and regulations for sale, manufacture of importation of narcotics. Only those exempted by the Act or approved by Commissioner of Internal Revenue after payment of tax of one dollar per annum may handle narcotics. Held valid.

(5) *Child Labor Tax Case*[38]—Tax of ten per cent of annual profits for *knowingly* employing child labor in interstate commerce, held invalid.

(6) *Hill v. Wallace*[39]—Tax of 20 cents a bushel on all contracts for the sale of grain for future delivery, excepting sales on boards of trade designated as contract markets by the Secretary of Agriculture on fulfillment by such boards of certain requirements set out by the Act, held invalid.

(7) *Florida v. Mellon*[40]—Tax on inheritance with 80 per cent rebate of amount paid under state inheritance law, held valid.

(8) *Hampton v. United States*[41]—Protective tariff, held valid.

(9) *United States v. Constantine*[42]—Special excise tax of $1000 on dealers selling liquors contrary to state law, held invalid.

(10) *United States v. Butler*[43]—Tax on processors found to form part of a scheme to regulate agriculture, held invalid.

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[34] 5 Wall. 462 (1866).
[35] 8 Wall. 533 (1869).
[36] 195 U. S. 27 (1904).
[37] 249 U. S. 86 (1919).
[38] 259 U. S. 20 (1922).
[39] 259 U. S. 44 (1922).
[40] 273 U. S. 12 (1927).
[41] 276 U. S. 394 (1928).
[42] 296 U. S. 287 (1934).
[43] 297 U. S. 1 (1935).

(11) *Carter v. Carter Coal Co.*[44]—Tax of 15 per cent of sale price or market value of bituminous coal, subject to a rebate equal to 13½ per cent to those producers who conformed to the Bituminous Coal Code, held invalid.

An examination of these decisions is a review in brief compass of the history of attempts of Congress to regulate by means of its taxing power matters otherwise reserved to the control of the states. We shall see that at first the Court was inclined to give wide leeway to congressional discretion in this respect. Beginning in 1922,[45] however, the tide turned, and after a group of adverse decisions had circumscribed the power, Congress permitted it to rest in abeyance. The advent of the New Deal found the national law-makers casting about for devices by which to augment federal power. Again they resorted to the power to tax, but with poor success to date.[46]

The first decision of importance on the subject of regulation by tax was that in the *License Tax Cases* of 1866[47] involving excise taxes on lottery and retail liquor businesses, activities forbidden by the laws of certain states. The defendant contended that Congress may not levy a tax on action prohibited by state law. In answer to this Mr. Chief Justice Chase replied as follows:

> "There is nothing hostile or contradictory in the acts of Congress to the legislation of the States. *What the latter prohibits, the former, if the business is found existing notwithstanding the prohibition, discourages by taxation. The two lines of legislation proceed in the same direction and tend to the same result.*"[48]

The fact that the tax effected regulation appeared to the court to be praiseworthy rather than ground for judicial suspicion.[49]

Shortly after this decision the Court had before it the celebrated case of *Veazie Bank v. Fenno* (1869),[50] the bank-note case.

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[44]298 U. S. 238 (1936).

[45]Child Labor Tax Case, 259 U. S. 20 (1922).

[46]See United States v. Butler, 297 U. S. 1 (1935); Carter v. Carter Coal Co., 298 U. S. 238 (1936).

[47]License Tax Cases, 5 Wall. 462 (1866).

[48]*Id.* at 473. Italics ours.

[49]The navigation, trade and sugar acts passed by Parliament in the middle of the 18th Century affecting the American Colonies were tax statutes but were not intended to produce revenue; they were for the regulation, restriction or prevention of trade. It cannot, therefore, be said that a tax, the purpose of which is to regulate, is anything new. Nor can it be said that the producing of revenue is necessarily a definitive quality of a tax. In fact, it was not until Great Britain imposed a tax for revenue purposes that the Colonies objected. McLAUGHLIN, CONSTITUTIONAL HISTORY OF THE UNITED STATES (1935) 28 *et seq.*

[50]8 Wall. 533 (1869).

The opinion does not even discuss motives of Congress. Mr. Justice Nelson in his dissent[51] hints darkly that the purpose of the act was to favor national banks at the expense of state banks. He does not rest his dissent on this ground, however, but contents himself with the following remarks:

> "We say nothing, as to the purpose of this heavy tax of some sixteen per centum upon the banks, ten of which we cannot but regard as imposed upon the power of the States to create them. Indeed, the purpose is scarcely concealed, in the opinion of the court, namely, to encourage the National banks. It is sufficient to add, that the burden of the tax, while it has encouraged these banks, has proved fatal to those of the States; and, if we are at liberty to judge of the purpose of an act, from the consequences that have followed, it is not, perhaps, going too far to say, that these consequences were intended."[52]

It was not until 1904 that another important case on this point came before the court. This was the oleomargarine case, *McCray v. United States* (1904).[53] The decision there rested almost entirely upon the principle that if the measure appears upon its face to be a tax, the courts may not question the motives or purposes of Congress in enacting it. Mr. Justice White refused to entertain the suggestion that the true purpose of the extremely high tax was to put out of business manufacturers of artificially colored oleomargarine.[54]

The case of *United States v. Doremus* (1919),[55] in which the Harrison Anti-Narcotic Act[56] was upheld, is the highwater mark of federal regulation by means of the taxing power. The Harrison Anti-Narcotic Act which was aimed at the complete control of trade in narcotics was inserted in its entirety in the general revenue act of 1919.[57] It provided that drugs could be handled only by persons registered with the commissioner of Internal Revenue. Unauthorized traffic was severely condemned. The tax of $1 per annum levied upon those who were authorized to deal in narcotics was the merest cloak to shield what would otherwise be an invalid regulation. In his opinion Mr. Justice Day reiterated the ancient test which was to receive only lip-service in later decisions of the court. He said: "If the legislation enacted has some reasonable

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[51] *Id.* at 549.
[52] *Id.* at 556.
[53] 195 U. S. 27 (1904).
[54] *Id.* at 51 *et seq.*
[55] 249 U. S. 86 (1919).
[56] 38 STAT. 785, 28 U. S. C. A. § 1040 (1914) *et seq.*
[57] 40 STAT. 1057, 26 U. S. C. A. § 1040 (1919) *et seq.*

relation to the exercise of the taxing authority conferred by the Constitution, it cannot be invalidated because of the supposed motives which induced it."[58] Needless to say, the learned justice neglected to point out what was the reasonable relation between a tax of one dollar per annum and the complete regulation of the drug traffic. It is interesting to note that Chief Justice White and Justices McKenna, Van Devanter and McReynolds dissented on the ground that the act invaded the reserved powers of the states.[59]

In the *Child Labor Tax Case* (1921),[60] the imposition of the tax depended upon whether the employer *knowingly* employed child labor. This incident so clearly marked the exaction as a penalty that further discussion seems unnecessary. As Mr. Chief Justice Taft remarked, "Scienter is associated with penalties not with taxes."[61] The oppressive tax of 10 per cent of the annual net profit of the offender also appealed to the court as cogent evidence that the exaction was a penalty and not a tax. The *Doremus* case[62] was distinguished by a piece of judicial legerdemain. The rule which Mr. Justice Day had stated in that case, but did not follow, was simply reiterated in a somewhat strengthened form. "The court, there [in the *Doremus* case] made manifest its view that the provisions of the so-called taxing act must be naturally and reasonably adapted to the collection of the tax and not solely to the achievement of some other purpose plainly within state power."[63] You will read the *Doremus* case in vain if you hope to discover in it a rule nearly so broad as that stated by the Chief Justice. The court did state that if the primary motive of taxation on proper subjects was to obtain revenue, the incidental motive of discouraging them by making their continuance onerous would not be unlawful. But the primary motive in the bank note,[64] the oleomargarine[65] and the drugs[66] cases could hardly be regarded as the raising of revenue.

The next case, appearing in the same volume of the reports of the Supreme Court, is *Hill v. Wallace* (1921),[67] the grain futures case. The Grain Futures Act[68] and Title IX have striking resemblances. If the writer thought that precedent meant anything in the application of constitutional standards he should be willing to

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[58]United States v. Doremus, 249 U. S. 86, 93 (1919).
[59]*Id.* at 95.
[60]259 U. S. 20 (1922).
[61]*Id.* at 40.
[62]249 U. S. 86 (1919).
[63]Child Labor Case, 259 U. S. 20, 43 (1922).
[64]Veazie Bank v. Fenno, 8 Wall. 533 (1869).
[65]McCray v. United States, 195 U. S. 27 (1904).
[66]United States v. Doremus, 249 U. S. 86 (1919).
[67]259 U. S. 44 (1922).
[68]42 STAT. 187, 7 U. S. C. A. §§ 1-17, c. 86 (1921).

say that the same rule of law must govern the Grain Futures Act and the Social Security Act. Not that there are not differences between the statutes. The Social Security Act was drawn with all the Machiavellian attention to dangerous legal precedent that would mark a merger between the Standard Oil Company and the United States Steel Corporation.

The statute in *Hill v. Wallace* is entitled "An Act taxing contracts for the sale of grain for future delivery, and options for such contracts, and *providing for the regulation of boards of trade,* and for other purposes."[69] There is no doubt that Congress desired to regulate trading in grain futures here, just as it desired to stamp out illicit traffic in drugs in the *Doremus* case, and just as it intended to regulate state unemployment insurance in Title IX.[70] Said Chief Justice Taft,

> "It is impossible to escape the conviction, from a full reading of this law, that it was enacted for the purpose of regulating the conduct of business of boards of trade through supervision of the Secretary of Agriculture and the use of an administrative tribunal consisting of that Secretary, the Secretary of Commerce, and the Attorney General. Indeed the title of the act recites that one of its purposes is the regulation of boards of trade."[71]

But how did the Court escape a similar conviction two years before with respect to the Harrison Anti-Narcotic Act? And what about Title IX? True, in the drug act and in Title IX some revenue is collected in any event, infinitesimal in the first, and small (10 per cent), compared with the total tax, in the second. The court then distinguished the bank-note and oleomargarine cases on the ground that they did not show on their face a scheme of detailed regulation. The *Narcotics* case was quietly ignored.[72]

It will be recalled that the court divided sharply in the *Narcotics* case. In a case[73] subsequent to the *Child Labor* and *Grain Futures* decisions, involving an interpretation of the Harrison Act, Mr. Justice McReynolds gratuitously pointed out that the Anti-Narcotic Act was probably overruled. He said,

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[69]Hill v. Wallace, 259 U. S. 44, 63 (1922). Italics by the Court.

[70]See Message of President Roosevelt to the Congress, 78 CONG. REC., June 8, 1934, at 10770, 10771, and 79 CONG. REC., Jan. 4, 1935, at 95; *Report of the Committee on Finance of the Senate*, No. 628.

[71]Hill v. Wallace, 259 U. S. 44, 66 (1922).

[72]It is interesting to note that in both Hill v. Wallace and the Child Labor Tax Case, Mr. James M. Beck, as Solicitor-general of the United States, argued strenuously for the existence of federal power. Hill v. Wallace, *supra* note 71, at 56-60; Child Labor Tax Case, 259 U. S. 20, 21-28 (1922).

[73]United States v. Daugherty, 269 U. S. 360 (1925).

> "The constitutionality of the Anti-Narcotic Act, touching which this Court so sharply divided in United States v. Doremus, 249 U. S. 86 was not raised below and has not been reconsidered. The doctrine approved in Hammer v. Dagenhart, 247 U. S. 251; Child Labor Tax Case, 259 U. S. 20; Hill v. Wallace, 259 U. S. 44, 67 and Linder v. United States, 268 U. S. 5, may necessitate a review of that question if hereafter properly presented."[74]

Accepting the suggestion, an unauthorized dealer in narcotics raised the point[75] that if regulations of the Narcotics Bureau applied as well to those who did not pay the tax as to those who did, the act was unconstitutional. This contention was dismissed by the court after a thorough re-examination of the *Doremus* decision. Chief Justice Taft reiterated the rule of the *Child Labor* and the *Grain Futures* cases that the exaction must be tax, not a penalty, and that only regulations in aid of the collection of the tax will be upheld. Then with judicial seriousness that would make a cat laugh the learned Chief Justice solemnly found that the elaborate restrictive measures of the Anti-Narcotic Act and the extremely severe penalties were imposed in an endeavor to insure the collection of a small tax from authorized handlers of narcotics and to prevent unauthorized handlers from evading the tax.

> "In interpreting the act we must assume that it is a taxing measure, for otherwise it would be no law at all . . . . Everything in the construction of § 2 must be regarded as directed toward the collection of the taxes imposed in § 1 and the prevention of evasion by persons subject to the tax. If the words can not be read as reasonably serving such a purpose, § 2 cannot be supported."[76]

The Chief Justice then gravely found that Section 9, which subjects anyone failing to comply with the requirements of the act to a fine of not more than $2,000 or imprisonment for not more than five years or both, was designed to prevent evasion of six dollars per annum on retail dealers in narcotics, and a stamp tax of one cent per ounce on packages of narcotics sold.[77] The rigid requirements for registration and the complete control over the sales of drugs which the Narcotics Bureau exercises were considered to be merely precautions taken to insure collection of the tax.

In addition to a long-standing liquor license tax of $25, the Revenue Act of 1926[78] imposed a special excise tax of $100 on every

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[74] *Id.* at 362, 363.
[75] Nigro v. United States, 276 U. S. 332 (1928).
[76] *Id.* at 341.
[77] *Id.* at 340, n. 1.
[78] 44 STAT. 9, 26 U. S. C. A. §§ 206, 792.

person carrying on the business of manufacturing or dealing in liquor contrary to the laws of any state. Suit for the amount of the special tax was brought in *United States v. Constantine.*[79] Final decision below not having been reached until after the repeal of Prohibition, the cause of action had to stand or fall without the aid of the Eighteenth Amendment. The court found that though labelled a tax, the exaction depended for its incidence upon a violation of law. In the mind of the court the so-called tax was a penalty, being ten times as great as the tax on lawful liquor businesses. It overlooked the fact that in the *McCray* case,[80] oleomargarine colored to look like butter was taxed *forty* times as heavily as the uncolored product. The fact that the condition of the imposition of the tax was the commission of a crime impressed the court as an indication that the exaction was a penalty. Undoubtedly, this is cogent reasoning. And yet it did not persuade the dissenting Justices Cardozo, Brandeis and Stone, who believed that illegal pursuit of an occupation need not escape untaxed when legitimate exercise is burdened. The disparity in the amount of the tax was explained by Mr. Justice Cardozo in the following words:

> "Congress may reasonably have believed that, in view of the attendant risks, a business carried on illegally and furtively is likely to yield larger profit than one transacted openly by law-abiding men. Not repression, but payment commensurate with the gains is thus the animating motive."[81]

In view of the widespread interest it has aroused, little need be said of the decision in *United States v. Butler.*[82] Here, for the first time in federal constitutional history, a taxing statute was invalidated on the ground that the proceeds of the tax were to be spent to regulate, a matter reserved to the states. The vice in the statute appears to be the fact that the tax and the expenditure of its proceeds were part and parcel of a single statutory scheme. If they had been totally separated and if the amount of the tax bore no relation to the amount of benefits to farmers, presumably the scheme would have been unassailable. The court intimated that an excise tax on processing cotton would have been within the competence of Congress. Moreover, if benefits to farmers had been paid out of the general fund of the treasury, no one could question the expenditure.[83] Hence, the drafters of the Social Security had to scan their act closely to see whether an unduly close alliance existed between tax and benefit payments.

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[79] 296 U. S. 287 (1934).
[80] McCray v. United States, 195 U. S. 27 (1904).
[81] United States v. Constantine, *supra* note 79, at 297.
[82] 297 U. S. 1 (1935).
[83] *Id.* at 61, 68 *et seq.*

In *Carter v. Carter Coal Co.*[84] a destructive tax on producers of bituminous coal with a rebate of 90 per cent to those who adhered to a detailed Bituminous Coal Code was invalidated. The Code was exceedingly detailed and unquestionably would effect complete regulation of the bituminous coal industry. This fact put the act in jeopardy because of the decisions condemning regulation by tax. But if Congress merely stated its objectives in broad terms, the act would be in danger of invalidation under the *Hot Oil*[85] and the *Schechter*[86] decisions. Despite the fact that at the oral argument the government withdrew its claim that the exaction could stand as a tax and rested it upon the power of Congress to regulate interstate commerce, the court examined the question in passing and characterized the exaction as a penalty notwithstanding its appearance as a tax with a 90 per cent rebate.

The Social Security Act

Title IX of the act was astutely drawn. Attempts were made to sidestep all dangerous precedents. No taint of 'scienter' appears and thus the *Child Labor* decision may be said to be inapplicable. The requirements for approval of state unemployment-insurance laws by the Social Security Board are few in number and simple in application. This avoids the difficulty in the *Grain Futures* and *Bituminous Coal* cases. A certain amount of revenue enures to the federal government in any case. This avoids those cases where revenue results only when an undesirable act is done, as for example in the *Child Labor, Grain Futures, Special Liquor Excise,* and *Bituminous Coal* decisions. The proceeds of the tax are covered into the general fund of the treasury, thus rendering it more difficult for the court to apply the *Butler* case.

On the other hand, from the point of view of the precedents, the following things may be shown to be wrong with the Social Security Act. The 90 per cent rebate is identical with that condemned in the *Bituminous Coal* case, and is similar to the 20 cent tax on grain futures transactions.[87] The regulations in the Social Security Act, while not so general as those condemned in the *Grain Futures* and the *Bituminous Coal* cases, are much more detailed than those in the *Child Labor* case. Moreover, the manifest purpose of the act is not to collect revenue. If and when all states have approved laws, the federal government will collect only 10 per

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[84]298 U. S. 238 (1936).

[85]Panama Refining Co. v. Ryan, 293 U. S. 388 (1935).

[86]Schechter Bros. Poultry Corp. v. United States, 295 U. S. 495 (1936).

[87]Although a similar rebate scheme was upheld in Florida v. Mellon, 273 U. S. 12 (1927), that case is really inapposite to the Social Security set-up since there was no regulatory scheme of any kind present in the Florida case. It involved inheritance taxes for revenue only.

cent of the tax, an amount which will probably be consumed in administrative expenses.

The only conclusion from the above review is that Congress may sometimes regulate by its taxing power matters not otherwise within the scope of federal control. What form the regulation may take, or what subjects may be regulated cannot be fathomed from the precedents. Every effort on the part of Congress to attach regulations to a taxing measure must withstand the scrutiny of the court. And anyone's guess is as good as anyone else's whether the act will be approved.[88]

Conclusion

What shall we say of a most important branch of constitutional law which appears to be a legal shambles? Are the cases completely unexplainable? Are they a series of judicial sports having no more solid foundation than the visceral reactions of the judges who decided them? The realists would have us believe so. And yet if this is true, the decisions are no longer to be regarded as legally important. They are case studies in the individual psychology of the judges or material for their biographers, but no more significant for lawyers than their personal correspondence. If, however, we say that the decisions are the legal reflections of the social and economic viewpoints of those judges who made up the majority of the court at the actual time of decision, we have something more substantial as a basis of inquiry. Ideas entertained by great masses of people can be studied. Individuals are ineluctable. If this way of looking at constitutional decisions is sound (and the writer believes it is) then the reaction of other social ideas on law is the explanation of these constitutional decisions. Does not law then disappear when politics and economics dictate decisions? Not at all, because politics and economics are still applied through the forms of law. And form always affects substance. But precedent, at least *legal* precedent, disappears, even though political and economic ideas persist and recur so as to be the true deciding factor in a line of cases.

Now, to the extent that non-legal considerations enter into the decision of a case the court is a policy-forming body. Influences brought to bear on it resemble those used on legislators. If previously decided cases do not greatly influence it (and we do not see how they can since they are contradictory) then consideration of

[88]Of vital importance in making such a guess is the case of Chamberlin, Inc. v. Andrews, 57 Sup. Ct. 122 (1936), in which the court in a memorandum opinion affirmed the decision of the New York Court of Appeals, 271 N. Y. 1, 2 N. E. (2d) 22 (1936), upholding the validity of the New York Unemployment Insurance Law. The affirmance was due to the fact that the Court was equally divided, Mr. Justice Stone not participating due to illness.

the desirability of the legislation must be uppermost in the minds of the judges when they decide. This must be so, and far from being deprecated, we believe that it is a desirable state of affairs. Binding precedents in the application of constitutional standards would be intolerable. However, much would be gained if the court would make its policy-forming function conscious and explicit. If it were to announce, for example, that constitutional precedents must always be viewed in the light of the social and economic milieu of which they are a part, then everyone would understand more clearly what it was doing. This was done with respect to the adoption of the English common law in America. Theoretically, only so much of it as was adapted to our conditions was received. On this analogy constitutional precedent would admittedly have the same status as precedents generally have in the Civil Law. In that system of law a long line of cases (jurisprudence) may not lightly be disregarded. But single instances or contradictory sets of cases are of no binding authority.[89]

Frank surrender of the theory of *stare decisis* in the interpretation of constitutional standards would result in no loss of legal certainty. Certainty does not exist at present since Congress can obtain no guidance from the decided cases in attempting to frame taxing statutes whose effect is the regulation of a subject otherwise reserved to the states. If, on the contrary, Congress were assured that modern legislation would be viewed by the court in the light of present-day conditions, it would feel much more free to legislate than is now the case. The program would call for judicial restraint, since judicial policy makers, or rather policy reviewers, would have to accord to their legislative colleagues a measure of discretion in the application of the constitutional standard.

It is conceived that this in effect is the position taken by the progressive members of the Supreme Court. True, Mr. Justice Stone has stated[90] that the court is concerned not with policy but only with the power of Congress under the Constitution. This is obfuscatory. He really means that the Constitution must be interpreted as a contemporary document whose standards need constant re-examination. Due process, for example, is like reasonable care. What was satisfactory a century ago might be gross carelessness now. What was inherent in the power to tax (the power to destroy) when Chief Justice Marshall spoke may be grossly contrary to our current *mores*. At any rate, it is our belief that the federal courts could gain in prestige if they would avowedly become policy reviewers of Congressional action where broad standards of constitutional power are in question.

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[89] 1 COLIN ET CAPITANT, DROIT CIVIL COURS ELEMENTAIRE (1934) 37 *et seq.*
[90] United States v. Butler, 297 U. S. 1 (1936).

THE USE FOR PERSONAL PROFIT OF KNOWLEDGE GAINED WHILE A DIRECTOR

*I. Beverly Lake**

In considering the legal right of a director to use for his personal advantage knowledge of the affairs of his corporation, acquired by virtue of his directorship, one must be careful to remember that the problem is, what is the director's legal right, and not, what is his moral right? Conscience ranges ahead of Law and scouts unoccupied regions. Law moves ahead slowly after digesting the conflicting reports and recommendations brought to it by Conscience. Sometimes Expediency, Greed and Envy clothe themselves in the garments of Conscience and bring in false reports which lead Law astray. Sometimes Conscience reports that the land ahead is fair and lovely but Experience warns of the difficulties which must be overcome, and suggests that if Law attempts to overcome these by a direct advance much valuable economic baggage will be lost and the nation will be thrown into such confusion that the cost of the conquest will be more than it is worth. In such a situation Law must choose between a conquest of the new land by a sudden advance, soon over, but producing confusion which may last long afterwards, and an absorption of the new land by letting Conscience lead individuals into it until the nation is in peaceful possession. It is well for Law to pause occasionally to ascertain, as nearly as possible, where it is, get fresh reports from Conscience, and consider them with the discretion Experience brings to the council.

Before examining data bearing on the present position of that portion of law which deals with the director's use of his knowledge, let us consider the preliminary questions: Why do corporations have directors? Why did the stockholders of *X* Company elect John Smith to a directorship in that company? There is nothing inherent in corporateness which requires that a corporation have a board of directors. It is entirely conceivable that a corporation could act without a board.[1] The only reason for having directors is that putting the management in the hands of a small board will enable this abstract thing we call the business to grow and to produce its goods or render its service efficiently and dispose of its products at a profit. John Smith was elected to the board because it was thought he knew how to run that kind of a business, or because he could bring to the company valuable friendships, or because the majority of stockholders thought he would obey orders, and, coupled with each of these alternative qualifications, it was thought that he

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[1] STEVENS, CORPORATIONS (1936) 546.

would be honest and would not steal from the business. That is, Smith was put on the board of directors because it was thought that the business would prosper from his connection with it. His duty then is to exert his energies and abilities to that end—the prosperity of the business. It is to be borne in mind that he was probably not the unanimous choice of the stockholders, and it is very likely that some individuals opposed his election, and distrust him.

The director is tempted to use the knowledge acquired through his directorship for private gain in the following situations: (1) When he is buying corporate property; (2) when he has an opportunity to buy property the corporation wants; (3) when he is engaged in a competing business; (4) when he holds the company's obligation; (5) when he is buying the company's obligation; and (6) when he is buying or selling on his own account stock in his company. Doubtless other situations arise.

I. When the Director is Buying Corporate Property

It is well settled that if a director casts the deciding vote in favor of the board's resolution to sell corporate property to himself, the sale is voidable at the option of the corporation.[2] This rule is but an application of the principles of agency. Here, the director is not simply using his knowledge, but is using the power of his office, which power was given him to be used for the good of the business. Since his personal interest is adverse to his duty to the business, the law properly condemns this use of his power and the conveyance is voidable at the option of the corporation without regard to the presence or absence of actual bad faith.

The generally accepted rule is that if the director, who is buying the property, does not cast the deciding vote in the meeting of the board, and especially if he does not vote at all, the conveyance will be valid in the absence of sharp practice or fraud.[3] There is some authority to the effect that the conveyance may be set aside at the option of the corporation even though the interested director did not control the meeting of the board and even though there was no fraud or bad faith on his part.[4] This minority view is unduly harsh and is unwise because it makes it impossible for a corporation to sell to its director, who oftentimes, in the case of the small corporation, is the only one to whom the corporation can turn for aid in a time of embarrassment. This situation presents the problem

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[2]Mobile Improvement Co. v. Glass, 142 Ala. 520, 39 So. 229 (1904).

[3]Nedry v. Vaile, 109 Ark. 584, 160 S. W. 880 (1913); Fort Payne Rolling Mill v. Hill, 174 Mass. 224, 54 N. E. 532 (1899); U. S. Steel Co. v. Hodge, 64 N. J. Eq. 807, 54 Atl. 1 (1903); Mfg. Co. v. Bell. 193 N. C. 367, 137 S. E. 132 (1927); Howard v. Tatum, 81 W. Va. 561, 94 S. E. 965 (1918).

[4]Stewart v. Lehigh Valley Co., 38 N. J. L. 505 (1875); Munson v. Syracuse R. R., 103 N. Y. 58, 8 N. E. 355 (1886).

of the director's use of his knowledge. There is a strong probability that the director who buys has some special information with reference to the property. Because of the fact that the director was placed in office charged with the duty of managing and disposing of corporate property so as to cause it to produce the greatest amount possible, the courts adopting the majority rule require the buying director to carry the burden of proving that he acted in good faith, disclosed to the corporation all the information he had, and paid a fair price.[5] Thus, where a director purchased property owned by his corporation and lying in another state, which property he had formerly managed for the corporation, and of which the other directors had little knowledge, it was held that the director's failure to disclose his knowledge of the property's qualities to the other directors made the conveyance to him voidable at the option of the corporation, the price he paid being clearly inadequate.[6] It is immaterial that the director is buying, not for himself, but for another corporation in which he is interested.[7]

A slightly different problem arises where the director buys the property of the corporation at a sale held by an officer of a court or a mortgagee. In such case the director is not using his power as director to bring about the sale. However, as long as he remains a director it continues to be his duty to protect, manage and dispose of corporate property so as to make it produce the greatest possible revenue. Consequently, the director buying at the third person's sale is in the same position as the director who buys from the corporation but does not cast a vote on the resolution. He must not buy at such sale until he has brought to the knowledge of the other directors everything he knows, which affects the value of the property, or the opportunity to redeem it, and of which he has cause to think the other directors are ignorant.[8] It follows, of course, that where the director wilfully failed to protect the corporate property from foreclosure and urged the creditor to foreclose so that the director might buy at the sale, which he did, the director has violated his legal obligation to the company.[9] It has been held that when-

[5]Wing v. Dillingham, 239 Fed. 54 (C. C. A. 5th, 1917); Lembeck & Betz Eagle Brewing Co. v. McAnarney, 287 Fed. 927 (W. D. N. Y. 1923); Orlando Orange Groves Co. v. Hale, 107 Fla. 304, 144 So. 674 (1932).

[6]Lembeck & Betz Eagle Brewing Co. v. McAnarney, 287 Fed. 927 (W. D. N. Y. 1923).

[7]O'Connor Mining Co. v. Coosa Furnace Co., 95 Ala. 614, 10 So. 290 (1891); Lazenby v. Henderson, 241 Mass. 177, 135 N. E. 302 (1922).

[8]Buchler v. Black, 213 Fed. 880 (W. D. Wash. 1914); McLean v. Bradley, 299 Fed. 379 (C. C. A. 6th, 1924); Lucas v. Friant, 111 Mich. 426, 69 N. W. 735 (1897); Janney v. Minneapolis Exposition, 79 Minn. 488, 82 N. W. 984 (1900); Coombs v. Barker, 31 Mont. 526, 79 Pac. 1 (1905); Gallogly v. Stender, 51 R. I. 303, 154 Atl. 280 (1931).

[9]Glen Allen Mining Co. v. Park Galena Mining Co., 77 Utah 362, 296 Pac. 231 (1931).

ever a director purchases at an execution sale he holds the property subject to the right of the corporation to disaffirm the sale and demand a resale without showing actual fraud or prejudice.[10] On the other hand, some decisions have gone so far as to hold that bankruptcy relieves the director of his obligations and that he may buy at the trustee's sale as could a stranger, the sale being fairly held.[11] It is submitted that both of these extreme views are erroneous, and that a director should, as when buying from the corporation, have the burden of proving that he did not bring about the sale, that it was fairly conducted, and that he disclosed to the corporation all the material facts in his possession about the sale and the property, but if he sustains this burden the sale should be sustained. Bankruptcy, or the appointment of a receiver, does not automatically terminate the corporate existence. The directors' active control of the business and property is suspended, but their moral duties remain the same, and it is submitted that their legal duties are likewise unchanged, at least so long as corporate life continues.

Where the director holds the obligation of the company, he may, so far as it is concerned, proceed to enforce it just as any other creditor may do, but before causing the property to be sold and buying it himself, he must inform the corporation that the sale is to be held and that he contemplates buying, and must disclose his knowledge as to the nature of the property so that the corporation will have a fair opportunity to protect itself.[12] Here again, the director is not simply using his knowledge for private gain, but is occupying a position inconsistent with his duty to manage and dispose of the property for the benefit of the business.

When the corporation is contracting with a stranger, the director cannot use his position to bring about the making of the contract and then take an assignment thereof from the other party. If he does so, he must account to the corporation for the profits he receives. The New Jersey Court had before it such a case.[13] There the corporation owned some periodicals which it wished to sell. Its lessee, whose affairs were known to one Bird, a director of the lessor, offered to buy the periodicals with certain long-term bonds of the lessee. This was flatly rejected, but the lessor gave the lessee a counter offer in the form of an option. Bird had contemplated buying the periodicals himself, which intention he did not

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[10]Fagan v. Stuttgart Normal Institute, 91 Ark. 141, 120 S. W. 404 (1909).

[11]Herring-Curtiss Co. v. Curtiss, 120 Misc. 733, 200 N. Y. S. 7 (Sup. Ct. 1923); *cf.* Janney v. Minneapolis Exposition, 79 Minn. 488, 82 N. W. 984 (1900).

[12]Marr v. Marr, 73 N. J. Eq. 643, 70 Atl. 375 (1908); Union Ice Co. of Philadelphia v. Hutton, 291 Pa. 416, 140 Atl. 514 (1928).

[13]Nat'l Manufacturers' Co. v. Bird, 97 N. J. Eq. 242, 127 Atl. 819 (Ch. 1925).

disclose to all the board, but did disclose to the principal shareholder. Bird took an assignment of the lessee's option and exercised it and then sold the periodicals to the lessee upon the terms set out in the lessee's original offer. The court, in holding that Bird was trustee of the bonds for the corporation said: "Who can say that if the defendant had openly and completely disclosed to the other members of the committee his reasons for thinking that an acceptance of the bonds would be advantageous to the plaintiff that the determination to have nothing to do with them would not have been changed?" This decision is consistent with the New Jersey decision[14] that a corporation may set aside a contract with its director even though there was no fraud and the director did not influence the vote of the other members. However, it seems harsh since the corporation had an opportunity to make the identical sale Bird made and rejected it, there being no evidence that Bird opposed such action nor any that he advocated the giving of the option.

It thus appears that so far as concerns a director's purchase of corporate property, Law has advanced as far as Conscience demands, and in some states has gone a bit beyond so as to make certain that the occupied territory will be protected from raids by unscrupulous directors.

II. When the Director Buys Property the Corporation Wants

If an agent employed to examine and buy certain property for his principal, proceeds to examine it at the principal's expense and ostensibly for his benefit, and upon finding that it can be bought for less than it is worth, buys it for himself, he is declared to hold it as trustee for the principal.[15] This well-settled principle of the law of agency is applied to the purchase of property from a stranger by a director of a corporation. The director has been placed in the directorship charged with the duty of managing the corporate property for the best interests of the business. The stockholders expect him not only to preserve and operate the properties placed under his direction, but also to take advantage of opportunities to acquire other properties which will contribute to the welfare of the business. On the other hand, one who accepts a directorship, is not expected to renounce his right to engage in transactions for his own account. In considering whether the director may buy for his own account a particular property, it is important to remember that the director is placed in the directorship to conserve and develop the

[14]Stewart v. Lehigh Valley Co., 38 N. J. L. 505 (1875).
[15]De Bardeleben v. Bessemer Land & Improvement Co., 140 Ala. 621, 37 So. 511 (1904).

business in which the corporation is engaged. In matters not concerned with that business, the director is as free from obligation to the corporation as is a stranger.

This limitation upon the director's duty to use his knowledge for the benefit of the corporation instead of for his own profit is well illustrated by a case decided by the Alabama Court.[16] There one La Garde, as director of the corporation, learned that it owned a one-third interest in a certain quarry, leased a second one-third interest therein, and had been negotiating for the purchase of the reversion and also the other one-third interest. As director he learned that the acquisition of the entire quarry would be of great benefit to the corporation. He bought the two-thirds interest for his own account, intending to quarry and sell lime in competition with the company. The court held that the acquisition of the one-third which the corporation held under a lease was a breach of his duty to the corporation since it had an expectancy of renewal therein. As to the other one-third interest the court held that he was within his legal rights in buying, since, while that property would have been valuable to the company, acquisition of it was not necessary to the company's business. La Garde had not been instructed by the company to buy the property for it, and its being owned by another would not impair the value of the company's two-thirds. It was considered immaterial that La Garde gained his knowledge as to the value of the property through his connection with the company. The court said: "Good faith to the corporation does not require of its officers that they steer from their own to the corporation's benefit, enterprises or investments, which, though capable of profit to the corporation, have in no way become subjects of their trust or duty." The decision as to the one-third not leased by the company seems incorrect in view of the fact that the director knew the corporation then desired to acquire that property, and that while negotiations had been suspended for the present by the corporation, it would probably reopen them. Under such circumstances Conscience condemns the director's buying without first offering the corporation an opportunity to do so on the terms offered to him, and it is submitted that his action is a clear violation of his undertaking to devote his judgment to the development of the business in which the corporation was engaged. However, the case is undoubtedly correct in limiting his duty to matters connected with the business which has been placed under his care.

The duty of the director has been well stated in an Arizona decision.[17] One Steinfeld, while not a director, so dominated the board that the court considered the case as if he had been a member of

[16]La Garde v. Anniston Lime & Stone Co., 126 Ala. 496, 28 So. 199 (1900).
[17]Zeckendorf v. Steinfeld, 12 Ariz. 245, 100 Pac. 784 (1909).

it. From certain reports of the company's superintendent, and other sources open to him by reason of his connection with the company, Steinfeld learned that neighboring properties were valuable for mining purposes. He bought them for his own account. Since he did not mislead the company by representations that he was buying for it, the court held that his purchase was not a violation of his duty to the company, saying,

> "Whether in any case an officer of a corporation is in duty bound to purchase property for the corporation, or to refrain from purchasing property for himself, depends upon whether the corporation has an interest, actual or in expectancy in the property, or whether the purchase of the property by the officer or director may hinder or defeat the plans and purposes of the corporation in the carrying on or development of the legitimate business for which it was created."

It is held that the director buys for the benefit of the corporation if, at the time of buying, he knew that the corporation would or did need the property and he intended to sell it to the corporation at an advanced price.[18] The same result is reached where the director bought knowing that the property in question was necessary to the efficient operation of the company's business even though he did not intend to resell to the company, and was not expressly delegated to buy for it.[19] Where the corporation is in possession of the property as lessee, it has, in absence of proof to the contrary, such an expectancy of renewal as amounts to a property right. Thus, when a director buys the reversion or procures a lease to himself to begin at the expiration of the corporation's present term, he acquires such interest for the benefit of the company.[20] On the other hand, it has been held that the director is perfectly free to buy for his own account when the company is not in the market for property of the kind, and the director bought with no intent to resell to the company.[21]

It has been held that the company's having negotiated for the purchase of the property does not prevent the director from buying

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[18]Harmony Way Bridge Co. v. Leathers, 353 Ill. 378, 187 N. E. 432 (1933); Parks v. Hughes, 145 La. 221, 82 So. 202 (1919); Gilmore v. W. J. Gilmore Drug Co., 279 Pa. 193, 123 Atl. 730 (1924); *cf.* Kahle v. Stephens, 214 Cal. 89, 4 P. (2d) 145 (1931); Dixmore Golf Club v. Evans, 325 Ill. 612, 156 N. E. 785 (1927); Bliss Petroleum Co. v. McNally, 254 Mich. 569, 237 N. W. 53 (1931).

[19]Nebraska Power Co. v. Koenig, 93 Neb. 68, 139 N. W. 839 (1913); *cf.* Tierney v. United Pocahontas Coal Co., 85 W. Va. 545, 102 S. E. 249 (1920).

[20]McCourt v. Singers-Bigger, 145 Fed. 103 (C. C. A. 8th 1906); La Garde v. Anniston Lime & Stone Co., 126 Ala. 496, 28 So. 199 (1900); H. C. Girard Co. v. Lamoureux, 227 Mass. 277, 116 N. E. 572 (1917).

[21]Carper v. Frost Oil Co., 72 Colo. 345, 211 Pac. 370 (1922); Bliss Petroleum Co. v. McNally, 254 Mich. 569, 237 N. W. 53 (1931); Tierney v. United Pocahontas Coal Co., 85 W. Va. 545, 102 S. E. 249 (1920).

for his own account even though he acquired his knowledge of the property and of the opportunity to buy it through his position as director,[22] negotiations being held not to give the company the required expectancy in the property, particularly in the absence of a showing that the company had a practical as distinguished from a theoretical or visionary use for it. These cases seem questionable, as the director is defeating the legitimate plans of the business he is charged with the duty of protecting and advancing. However, the Mississippi Court quite properly held that the director is free to buy for himself when the seller has rejected the corporation's offer and testifies that he would not have disposed of his property to it, the director's purchase not having any tendency to cripple the existing business.[23]

It has been held that after the director's term has expired, he may buy for himself stock in another corporation though he learned while a director that the first corporation was negotiating for the purchase of the stock of the second so as to effect a merger.[24] The termination of the director's relation should not affect the director's right to make such a purchase. He should not be allowed to buy if it appears that his motive was to block the merger or to force the first corporation to buy his stock in the second at an enhanced price. Such use of knowledge acquired by him by virtue of his position is certainly contrary to good morals, and seems to be contrary to his legal duty to use his knowledge for the good of the business.

III. When the Director Engages in a Competing Business

While a director may accept his position on the express condition that he may engage for himself in a similar business at the same time,[25] it is ordinarily inconsistent with his duty to use his judgment for the advancement of the corporation's business for him to engage in a rival enterprise. There is an incentive to use his knowledge of the corporation's condition and plans for the benefit of the rival business. One does not, in accepting a directorship, agree or become obligated to refrain from all other business activities. Consequently, the director may engage in other businesses even though such other businesses are of the same nature as that carried on by the corporation,[26] and, thereafter, if the corpo-

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[22]La Garde v. Anniston Lime & Stone Co., 126 Ala. 496, 28 So. 199 (1900); Colorado & Utah Coal Co. v. Harris, 97 Colo. 309, 49 P. (2d) 429 (1935).

[23]Pioneer Oil & Gas Co. v. Anderson, 168 Miss. 334, 151 So. 161 (1933).

[24]Holmes v. Doe Run Lead Co., 223 S. W. 772 (Mo. App. 1920).

[25]Anderson v. Dunnegan, 217 Iowa 672, 250 N. W. 115 (1933).

[26]Barr v. Pittsburgh Plate Glass Co., 57 Fed. 86 (C. C. A. 3rd, 1893); Lancaster Loose Leaf Tobacco Co. v. Robinson, 199 Ky. 313, 250 S. W. 997 (1923); Detroit Fidelity & Surety Co. v. First Nat'l Bank of Wichita Falls, 66 S. W. (2d) 406 (Tex. Civ. App. 1933); *cf.* Red Top Cab Co. v. Hanchett, 48 F. (2d) 236 (N. D. Cal. 1931); Coleman v. Hanger, 210 Ky. 309, 275 S. W. 784

ration wishes to buy the director's plant, he may sell it to the corporation just as he may sell to it any other property owned by him.[27] On the other hand, the director is not permitted to enter into a competing business such as would cripple or injure the corporation, and instruments or property he has acquired for that purpose may be impounded for the benefit of the corporation.[28]

The corporation's business secrets and prospects, just as its tangible properties, are placed under the director's care so that he may use and develop them for the corporation's advantage. When the director uses his knowledge of the corporation's condition and plans, and the acquaintances with its customers, which come to him by virtue of his position, to undermine the corporation's business and divert to himself valuable contracts which the corporation is seeking to make with prospective customers, he holds the fruits thereof in trust for the corporation.[29] If the director has taken from the corporation's file a list of its customers and prospective customers, and papers showing its business methods, and is using the information therein contained to discredit the corporation in the eyes of its customers and prospective customers for the purpose of diverting to himself business the corporation could normally expect, the corporation may secure an injunction restraining him from making use of or disclosing such information.[30] Conscience condemns the director's appropriation to himself of business opportunities fairly belonging to the corporation, particularly where his knowledge of them is derived through his directorship, and so does Law.[31] However, where the corporation has had a fair opportunity to make a desired contract, the director in no wise interfering with its negotiations, he may thereafter form a new corporation and procure the contract for it, provided such action will not cripple the corporation in the conduct of its existing business.[32]

Ordinarily the director may sell his own stock at a price above the prevailing market, without first giving the corporation an opportunity to sell its treasury stock, just as he may sell other property without first giving the corporation a chance to dispose of

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(1925); Young v. Columbia Oil Co. of W. Va., 110 W. Va. 364, 158 S. E. 678 (1931).

[27]Barr v. Pittsburgh Plate Glass Co., 57 Fed. 86 (C. C. A. 3rd, 1893).

[28]McCourt v. Singers-Bigger, 145 Fed. 103 (C. C. A. 8th, 1906); Red Top Cab Co. v. Hanchett, 48 F. (2d) 236 (N. D. Cal. 1931); Coleman v. Hanger, 210 Ky. 308, 275 S. W. 784 (1925); Hussong Dyeing Machine Co. v. Morris, 89 Atl. 249 (N. J. Eq. 1913).

[29]Beaudette v. Graham, 267 Mass. 7, 165 N. E. 671 (1929).

[30]Southwest Pump & Machinery Co. v. Forslund, 225 Mo. App. 262, 29 S. W. (2d) 165 (1930); *cf.* Chicago Flexotile Floor Co. v. Lane, 188 Minn. 422, 247 N. W. 517 (1933).

[31]Brite v. Penny, 157 N. C. 110, 72 S. E. 964 (1911).

[32]Davis v. Pearce, 30 F. (2d) 85 (C. C. A. 8th, 1928).

similar property owned by it, but he must not undercut the corporation, nor may he so sell his stock for the purpose of giving a rival company a controlling interest in his corporation.[33]

The director's knowledge of the corporation's business secrets must be distinguished from general experience in and knowledge of the type of business done by the corporation. Consequently, while resigning his directorship does not, of itself, free the director from the restraint imposed by law upon his personal use of his knowledge of the corporation's condition and plans,[34] a former director, after resigning his directorship, may engage in a rival business and use therein the general skill and knowledge acquired as director.[35]

IV. When the Director Prefers Himself as Creditor Over Other Creditors

The director who is also a creditor of his corporation, necessarily knows more about the condition of the company than does the ordinary creditor. The outside creditor has no right to examine the books of the corporation, and of course does not know what goes on in the directors' meetings. Consequently, he knows no more about the affairs of the corporation than does the public generally. While he may have made a careful investigation of its financial condition at the time of extending credit to it, he does not have means of ascertaining what has happened since that time. The director-creditor, on the other hand, is in a position to know everything about the company's condition, as well as what it plans to do and what forces threaten its continued ability to pay all of its debts in full. He knows when insolvency is drawing near. He knows the company's property and which assets are available for the satisfaction of his claim, and which are likely to be worth enough to pay his claim if he can take them. If the director, perceiving the danger of insolvency, secures his claim by taking a mortgage or a lien by legal process, or if he takes from the treasury money of the company to the full amount of his claim, he does not thereby injure the corporation. It has no cause for complaint when he takes from it no more than its debt to him. Therefore, it is generally held that the director who is also a creditor of the corporation, may enforce his claim against it by any legal proceedings open to other creditors.[36]

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[33]Stanton v. Schenck, 242 N. Y. S. 172 (Sup. Ct. 1931).

[34]Southwest Pump & Machinery Co. v. Forslund, 225 Mo. App. 262, 29 S. W. (2d) 165 (1930).

[35]N. Y. Automobile Co. v. Franklin, 97 N. Y. S. 781 (Sup. Ct. 1905).

[36]Schnittger v. Old Home Consol. Mining Co., 144 Cal. 603, 78 Pac. 9 (1904); Todd v. Temple Hospital Ass'n, 96 Cal. App. 42, 273 Pac. 595 (1929); Bossets v. Geis, 57 Ind. App. 384, 107 N. E. 95 (1914); H. B. Rice & Co. v. Miners' Elkhorn Coal Co., 234 Ky. 580, 28 S. W. (2d) 873 (1930); Caldwell

The director's duty being to use his knowledge and judgment so as to best serve the interests of the corporation by conserving and developing its business, a mortgage or pledge of corporate assets to secure a debt due the director from the company will be viewed with suspicion, and the burden is upon the director, if it is attacked, to show that the loan and giving of security were *bona fide* transactions.[37] If the director proves the existence of his claim and the *bona fides* of the mortgage or pledge, it will be upheld[38] and the director may foreclose upon default just as may any other secured creditor. The same principles apply to a mortgage or pledge to indemnify him against loss by reason of his having lent the corporation his credit by indorsing its paper.[39] No harm can come from allowing the director to exercise such rights after he has established that the transactions were characterized by good faith. A contrary rule would make it impossible for the corporation to borrow money from the director or on his indorsement, and in times of general economic stress would force large numbers of small corporations into liquidation. The director who pays the company's debt to another is in the same position as the director who makes a direct loan to the company, and is generally subrogated to all the rights of the former creditor.[40] One case[41] has gone so far as to hold that a director may lend money to the corporation, take its note secured by a mortgage, though the corporation does not know the director is the real lender, and on default may foreclose and buy the property at the foreclosure sale, though such ultimate acquisition of the property was the director's intention at the time of making the loan. Such plotting against the corporation by one who is under a duty to use his judgment and knowledge for its benefit is dishonorable and probably would not be tolerated by most courts.

It has been held that officers and directors of a corporation occupy a fiduciary relation to the creditors when the corporation has

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v. Robinson, 179 N. C. 518, 103 S. E. 75 (1920); Jones v. Hale, 32 Ore. 465, 52 Pac. 311 (1898).

[37] H. B. Rice & Co. v. Miners' Elkhorn Coal Co., 234 Ky. 580, 28 S. W. (2d) 783 (1930); Bossert v. Geis, 57 Ind. App. 384, 107 N. E. 95 (1914); Cornelius v. C. C. Pictures, Inc., 7 F. (2d) 308 (C. C. A. 2nd, 1925).

[38] Pierce v. Nat'l Bk. of Commerce, 13 F. (2d) 40 (C. C. A. 8th, 1926); Gilman v. F. O. Bailey Carriage Co., 127 Me. 91, 141 Atl. 321 (1928); Scully v. Colonial Tr. Co., 105 N. J. Eq. 309, 147 Atl. 776 (1929); First Nat'l Bk. of Binghampton v. Commercial Travelers Home Ass'n of America, 95 N. Y. S. 454 (App. Div. 3d, 1905); Jones v. Hale, 32 Ore. 465, 52 Pac. 311.

[39] H. B. Rice & Co. v. Miners' Elkhorn Coal Co., 234 Ky. 580, 28 S. W. (2d) 783 (1930).

[40] Ready v. Smith, 170 Mo. 163, 70 S. W. 484 (1902); Caldwell v. Robinson, 179 N. C. 518, 103 S. E. 75 (1920); Rawlings v. New Memphis Gaslight Co., 105 Tenn. 268, 60 S. W. 206 (1900).

[41] Schnittger v. Old Home Consol. Mining Co., 144 Cal. 603, 78 Pac. 9 (1904).

become insolvent.[42] However that may be, the director who holds a claim against the corporation, does stand in a much more advantageous position than does the outside creditor, when the corporation is on the verge of insolvency or actually insolvent and the creditors begin to take steps looking toward collection of their claims. The general rule is that until bankruptcy or receivership intervenes, creditors are free to race for the assets of the failing debtor. Where the debtor is a corporation and one of the creditors is a director, he is in a position to hear the starting gun before his competitors, and if he yields to the natural temptation to be up and doing, he will be off to a flying start before the others know the race is on, and will have consumed all the cream on the milk when the others come panting along. Even the ordinary creditors' race leads to injustice and it is against conscience to allow it. Furthermore, it penalizes the creditor who stops to help the tottering debtor before sprinting for the courthouse. When there is the added fact that one creditor by virtue of his intimate connection with the corporation is in a position to "jump the gun," all reason demands that he be disqualified to win the prize. Therefore, it is generally held that when the corporation is insolvent the director cannot secure a preference to himself over the other creditors by taking a mortgage or pledge to secure his pre-existing debt.[43] These arguments apply with even more strength to preferential payments to directors made with knowledge of the corporation's insolvency.[44]

Where the director holds a pre-existing claim against the corporation and lends more money to it, it has been held that he may, at the time of making the second loan, take a mortgage to secure both claims, provided he is dealing honestly and making a *bona fide* effort to aid the corporation, and is not making the new loan in order to get a preferential security for the former one.[45] A minority group of decisions is to the effect that the insolvency of the corporation does not affect the right of the director to reduce his

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[42]Tampa Waterworks Co. v. Wood, 97 Fla. 493, 121 So. 789 (1929).

[43]Koehler v. The Black River Falls Iron Co., 67 U. S. 715 (1862); Stuart v. Larson, 298 Fed. 223 (C. C. A. 8th, 1924); Cornelius v. C. C. Pictures, Inc., 7 F. (2d) 308 (C. C. A. 2nd, 1925); Trindale v. Atwater Canning & Packing Co., 128 Pac. 756 (Cal. App. 1912); Bossert v. Geis, 57 Ind. App. 384, 107 N. E. 95 (1914); Mica Products Co. v. Heath, 81 N. H. 470, 128 Atl. 805 (1925); *In re* Estate of Mechanics' Bldg. & Sav. Ass'n, 202 Pa. 589, 52 Atl. 58 (1902); see THOMPSON, CORPORATIONS (3d ed. 1927) § 6192.

[44]Jackman v. Newbold, 28 F. (2d) 107 (C. C. A. 8th, 1928); Teague v. Teague Furniture Co., 201 N. C. 803, 161 S. E. 530 (1931). It is a violation of the National Banking Act for a director of such a bank to withdraw, with knowledge of the insolvency of the bank, his own deposit, or cause to be withdrawn the deposit of a corporation in which he is also a director, the withdrawal being for the purpose of obtaining a preference. Mechanics' Universal Joint Co. v. Culhane, 57 Sup. Ct. 81 (1936).

[45]Powell Bros. v. McMullan Lumber Co., 153 N. C. 52, 68 S. E. 926 (1910).

claim to judgment,[46] secure a preferential lien by attachment or garnishment,[47] or procure from the corporation a preferential mortgage or payment.[48] The majority view is unquestionably sound both in conscience and in law. It can be sustained in most instances upon the familiar doctrine of setting aside fraudulent conveyances.[49] The director is not only using his superior knowledge to obtain an advantage over the other creditors, but in many cases is also using his power as a director to bring about the conveyance to himself or to make it easier for him to obtain a judgment. There is little danger of the director's being actually hurt by the majority rule. If other creditors seem about to obtain a preference over him, he is in a position to protect himself by causing the corporation to institute voluntary proceedings in bankruptcy.

V. When the Director is Buying the Corporation's Outstanding Obligations

Generally there is one of two reasons for a director's buying the outstanding obligations of his company. He may make the purchase in order to protect his own investment, which may be in the form of a subordinate obligation of the company or may be merely his stockholder's interest. He may make the purchase because he knows, or thinks he knows, of facts which make it probable that the company will ultimately pay on the obligation a larger amount than the price at which he buys. The latter is, no doubt, the reason for most such purchases.

If the director purchased the obligation in order to protect his own investment there is practically no danger that anyone else will be injured by his action.[50] The seller is, by hypothesis, in an advantageous position and so is the one to dictate terms. Consequently, he will generally get an adequate price in absence of actual fraud, for which there is adequate relief available to him. The corporation and the other stockholders can hardly be injured by the director's purchase; for, in protecting his own subordinate interest, whether as junior creditor or as stockholder, he is of necessity protecting the corporation and the other stockholders. He has, by hypothesis, no secret information and no business opportunity to share with his fellow stockholders or to offer to his corporation. Furthermore, if his purchase is for the protection of his interests it is necessarily true that the corporation is not in a position to

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[46] O'Rourke v. Grand Opera House Co., 47 Mont. 459, 133 Pac. 965 (1913).
[47] McCormick v. Cornell & Wardlaw, 193 S. W. 1083 (Tex. Civ. App. 1916).
[48] Heidbreder v. Superior Ice & Cold Storage Co., 184 Mo. 446, 83 S. W. 466 (1904); McCormick v. Cornell & Wardlaw, 193 S. W. 1083 (1916).
[49] CLARK, CORPORATIONS (3d ed. 1916) § 213.
[50] Scott v. Norton Hardware Co., 54 F. (2d) 1047 (C. C. A. 4th, 1932); Stevens v. Laub, 38 Wyo. 182, 265 Pac. 453 (1928).

make the purchase at the time, else he would have wanted it to do so.

If the director has purchased the obligation because he expects to make a direct profit either by a resale or by holding until maturity and then collecting a larger amount from the debtor corporation, he may have done so because he knew facts about the corporation unknown to others, or because, having only the light that others have, his judgment is that the obligation is worth more than the price for which he can buy it. In the latter case there is neither a moral nor a legal wrong done the creditor. The only question in such a situation is as to the right of the corporation to treat the purchase as having been made for its benefit. The solution of this problem turns upon the ability and desire of the corporation to make the purchase. Essentially it is the same problem that is involved when the director buys for himself other property owned by a stranger and desired by his corporation.

If the corporation is financially able to buy the obligation at the agreed discount, and particularly if the corporation has formulated a plan for doing so and has delegated the director to negotiate on its behalf for such purchase, the director's duty is to buy for it, and not for himself until his *bona fide* efforts to buy for the corporation have failed, and he has disclosed to the corporation his purpose to drop negotiations on its behalf and continue them on his own.[51] Thus, where the director was a member of a committee appointed by the corporation to compromise the debts it owed, though the committee had rejected the creditor's offer to settle the claim for one-third, it was held that the director could not buy the claim on his own account at that figure and then assert the claim against the corporation for the face value.[52] This decision can be sustained on the ground that the director did not announce his intention to withdraw from the committee and buy on his own account. Had he done so there could have been no cause for complaint on the part of the corporation. At the time the corporation was insolvent and the court may have taken the position that the director's act and claim was a violation of the rights of the other creditors.[53] Such a position is unsound, for there was no preferential payment to the director on the claim so bought, and had he not bought it the other

[51] *In re* McCrory Stores Corp., 12 F. Supp. 267 (S. D. N. Y. 1935); Horner v. New South Oil Mill, 130 Ark. 551, 197 S. W. 1163 (1917); The Telegraph v. Lee, 125 Iowa 17, 98 N. W. 364 (1904); Ryan v. Leavenworth Ry., 21 Kan. 365 (1879); Bramblet v. Commonwealth Land & Lumber Co., 26 Ky. L. 1176, 83 S. W. 599 (1904); *In re* Allen-Forster-Willett Co., 227 Mass. 551, 116 N. E. 875 (1917); Young v. Columbia Land & Inv. Co., 53 Ore. 438, 101 Pac. 212 (1909).

[52] Horner v. New South Oil Mill, 130 Ark. 551, 197 S. W. 1163 (1917).

[53] Martin v. Chambers, 214 Fed. 769 (C. C. A. 5th, 1914); Bramblet v. Commonwealth Land & Lumber Co., 26 Ky. L. 1176, 83 S. W. 599 (1904).

creditors would have been in the same position. Under such circumstances the creditors can stand in no better position than the corporation. Certainly, if there is a reason for a distinction between the case of the solvent corporation and that of the insolvent one, it is the solvent corporation which has cause for complaint, since the shareholders will get back nothing from the insolvent corporation's liquidation in any event. A secret purchase by the treasurer-director and a secret payment of the face value to himself presents a different case.[54]

Since the director was made a director for the purpose of giving the corporation the benefit of his judgment and knowledge, the director should not buy the corporation's obligations at a discount and then assert a claim for the full amount until he has given the corporation the benefit of his information and judgment.[55] Morally, the corporation's position in such case is none too strong, for, after all, it is asked to pay only what it promised to pay, and presumably no more than it received originally as consideration for the promise. However, the director, in accepting his position, by implication agrees to give the corporation priority over himself in all matters pertaining to the management of its business. It is his duty to conserve its resources to the best of his ability, and if the creditor is willing to settle the claim at a discount, this opportunity should be given to the corporation before the director buys the claim and terminates it.[56] So far as the rights of the corporation are concerned there is no basis for a distinction between the case in which the director buys because of special information which he does not disclose and the case in which he buys because, in the light of facts known to all, his judgment leads him to conclude that the corporation will ultimately pay more than the price asked. The corporation is entitled to both his knowledge and his judgment. Having both and refusing to follow his advice, it is not entitled to object to his making an investment it does not want.[57]

If the director learns of the opportunity to buy the obligation while a director and resigns his directorship and then buys the claim, the result should be the same as where he buys while still a

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[54]The Telegraph v. Lee, 125 Iowa 17, 98 N. W. 364 (1904).

[55]Ryan v. Leavenworth Ry., 21 Kan. 365 (1879); Bramblet v. Commonwealth Land & Lumber Co., 26 Ky. L. 1176, 83 S. W. 599 (1904).

[56]*In re* Allen-Foster-Willett Co., 227 Mass. 551, 116 N. E. 875 (1917); Young v. Columbia Land & Investment Co., 53 Ore. 438, 101 Pac. 212 (1909).

[57]Martin v. Chambers, 214 Fed. 769 (C. C. A. 5th, 1914); Bellaire Securities Corp. v. Brown, 168 So. 625 (Fla. 1936); Camden Safe Dep. & Tr. Co. v. Citizens Ice & Cold Storage Co., 69 N. J. Eq. 718, 61 Atl. 529 (1905); Seymour v. Spring Forest Cemetery Ass'n, 144 N. Y. 333, 39 N. E. 365 (1895); Glenwood Mfg. Co. v. Syme, 109 Wis. 355, 85 N. W. 432 (1901).

director.[58] The violation of his duty by the director is not in his purchase but in his failure, through selfish motives, to disclose to the corporation his knowledge and give it the benefit of his judgment while a director. Therefore, the wrong to the corporation was done while the relation continued, not when the director's purchase was made. It has been said[59] that when a receiver is appointed for the corporation the directors are shorn of their powers and the fiduciary relation is terminated so that thereafter a director may purchase the corporate obligations and assert them for their face values just as anyone else may do. This is entirely correct if the director did not perceive the opportunity until after the receiver was appointed; but there is no basis for the application of such a rule to the case of a director who perceived the opportunity before the receivership, for in that event it was his duty to give the corporation the benefit of his knowledge and judgment before the receivership took effect.

When the director knows facts which make the corporation's obligations worth more than their market value, and, without disclosing this information, buys the obligation at the market price, has he violated any duty to the selling obligee? Of course, if he has made fraudulent misstatements in inducing such sale to himself, the transaction can be set aside by the defrauded seller. Where no such misstatements have been made but the director has simply kept silent, the selling obligee asking no questions, no authority has been found by the writer to the effect that the director has violated any duty to the seller. Doubtless the orthodox view of such a case would be that the director owes to the obligee no duty to inform him of facts affecting the value of his claim against the corporation. A number of cases, which are discussed in the next section of this paper, have held that a director must disclose, without waiting to be asked, all information he has about the company before buying shares of its stock from a fellow stockholder. The argument that such a disclosure by the director to creditors might injure the corporation in that the director's information may relate to the secret plans of the corporation, disclosure of which would destroy or diminish their value to the company, can be refuted just as the similar argument can be refuted in the case of the director's purchase of stock. If the director's knowledge is of such a confidential nature that his duty to the corporation forbids him to disclose it, then the director must stay out of the market.

There is a distinction between the creditor of the corporation, whose claim represents a current obligation of the company, and a

[58] So held in *In re* McCrory Stores Corp., 12 F. Supp. 267 (S. D. N. Y. 1935).

[59] *In re* Allen-Foster-Willett Co., 227 Mass. 551, 116 N. E. 875 (1917).

bondholder. The current creditor does not regard the director as his friend, but deals with him at arm's length as a representative of a hostile interest. On the other hand, the holder of a long-term bond is in reality an investor in the business. In making his investment, he looks not only to the assets of the company at the time of investment, but extends credit because he believes in the company's future, and trusts the directors, present and future, to so conduct the affairs of the business that his investment will be safe. The director in legal theory represents a hostile interest, but in practice the bondholder, particularly the small bondholder, does not so regard him. There is essentially no difference in this respect between the bondholder and the holder of non-voting, non-participating, cumulative preferred stock. The only difference between them is in the matter of priority. The nature of their interests is the same, and that is particularly true if the bond is convertible into stock. The director's moral duty to disclose his knowledge of the corporation's condition and prospects before buying such a bond is as great as is his duty to make such disclosure before buying such stock, or, it seems to the writer, any other stock. Conscience calls a purchase without disclosure "sharp practice" and "taking unfair advantage" in the one case as well as in the other. If Law calls such a purchase of stock "fraudulent and voidable," as the said cases hold, then Law should apply the same epithet to such a purchase of bonds. It is the writer's opinion that the cases are wrong in holding that the director, because of his directorship alone, owes any legal duty to make such disclosure before buying stock, and, therefore, there is no such duty of disclosure before buying bonds.

VI. When the Director is Buying Stock in the Corporation

Since the directors are placed in power for the purpose of protecting and developing the business, when they learn of an opportunity to sell stock in the corporation they may not issue to themselves stock which has not been previously issued, and then resell at an increased price.[60] This is true though the other stockholders have no preëmptive right in such stock.[61] When new stock is offered at a public sale, the director's duty to the corporation requires him to refrain from using for his own profit information as to the value of the stock, which information is not disclosed to other bidders.[62] However, in absence of statute, the corporation has no interest in the director's purchase of its shares from a fellow shareholder, since he is not dealing with its property.[63]

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[60]Hechelman v. Geyer, 248 Pa. 430, 94 Atl. 188 (1915); Upton v. Southern Produce Co., 147 Va. 937, 133 S. E. 576 (1926).

[61]Borg v. International Silver Co., 11 F. (2d) 147 (C. C. A. 2nd, 1925); Schwab v. Schwab-Wilson Machine Corp., 55 P. (2d) 1268 (Cal. App. 1936).

[62]Borg v. International Silver Co., 11 F. (2d) 147 (C. C. A. 2nd, 1925).

[63]Keely v. Black, 91 N. J. Eq. 520, 111 Atl. 22 (1920).

The Securities Exchange Act of 1934, in order to prevent the unfair use of information, provides that if the securities of the corporation are listed on a national exchange, any profit realized by a director from a purchase and sale or sale and purchase within a period of six months, with minor exceptions, shall innure to and be recoverable by the corporation.[64] The statute is penal in character and is not based upon the existence of any fiduciary relation between the director and the corporation. It applies also to an officer and to an owner of more than ten per cent of any class of any equity security issued by the corporation. It does not apply if more than six months intervene between the purchase and sale. The advisability of making the director accountable to the corporation rather than to the person from whom he bought the shares has been questioned.[65]

There are differences of opinion in regard to the director's duty to the individual stockholder from whom the director buys shares in his corporation. Conscience condemns the director who acquires information of facts materially affecting the value of the stock through his position, and who buys from his fellow shareholder without disclosing it, knowing that the seller is ignorant of the facts and relies upon the director to tell him everything of importance. The director, who buys in such a way would, no doubt, be loud in his abuse of a fellow director so treating him. But, while Conscience is fairly clear on the point, Law is in great confusion.

There is practically no disagreement upon the proposition that if the shareholder inquires of the director as to the condition of the corporation, or as to its plans, he is entitled to full and accurate information, unless such disclosure would be detrimental to the interests of the corporation.[66] If the information is of such a nature that the director's duty to the corporation prevents him from disclosing it, he need not do so, but he is not given any greater right to buy his fellow shareholder's stock without disclosure in such case than in the case where the fact could have been disclosed. If there is a duty to the corporation not to disclose and a duty to the shareholder to disclose before buying, both duties can be performed if the director foregoes the opportunity to buy. The shareholder certainly has the right to rely upon the truthfulness of positive state-

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[64] 48 STAT. 896, 15 U. S. C. A. § 78p. (1934).

[65] STEVENS, CORPORATIONS (1936) 584, n.

[66] Farmers Loan & Trust Co. v. Pierson, 222 N. Y. Supp. 532 (Sup. Ct. 1927); McMynn v. Richardson-Phoenix Co., 186 Wis. 442, 201 N. W. 272 (1924); Schroeder v. Carroll, 192 Wis. 460, 212 N. W. 299 (1927); *cf.* Poor v. Yarnell, 28 Cal. App. 714, 153 Pac. 976 (1915).

ments by the director,[67] though one case[68] seems to indicate that it is all right for a director to deceive his fellow director by positive misstatements, provided the fellow director has been a member of the board for a reasonable period, apparently on the ground that directors who have been working together very long should know better than to rely upon each other.

If a director discloses information to one stockholder for the purpose of enabling him to prey upon his fellows, the director acts wrongfully; but the stockholder is entitled to information as he is the real owner of the business[69] and if the director answers his inquiries in good faith the director is not responsible to a second shareholder who has been duped by the first, the second having made no inquiry of the director.[70] An interesting question is presented where the director, in attempting to buy stock, makes such disclosure and the stockholder thereupon rejects the director's offer, but goes to a second shareholder and buys his stock without disclosing what the director has told him. The first stockholder has gotten his information without inquiring of the director. Can the second complain of the director for not telling him the same thing? No authority has been found upon this point, but to hold the director liable to the second shareholder would seem to be carrying his duty of disclosure too far. To so hold would make it impossible for a director to buy more stock in his company.

When the shareholder has made no inquiry there are three views as to the duty of the director to disclose what he has learned through his directorship: (1) That the director owes no such duty, but may buy as if he were a stranger to the corporation; (2) that the director owes no such duty by reason of his directorship, but may owe such a duty because of the special circumstances surrounding the transaction; (3) that the director is in a fiduciary relation to the individual shareholders of his company and cannot buy their shares without a full and complete disclosure of his information.

On the ground that the director is not a trustee of the individual stockholder's shares, since the director has no title to, or dominion over, the shares, but the shareholder may deal with them as he chooses, the Indiana Court held that the director in buying such shares need not disclose to the seller his information concern-

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[67] McMynn v. Richardson-Phoenix Co., 186 Wis. 442, 201 N. W. 272 (1924); Schroeder v. Carroll, 192 Wis. 460, 212 N. W. 299 (1927).

[68] Richards v. Foss, 126 Me. 413, 139 Atl. 231 (1927).

[69] Farmers' Loan & Trust Co. v. Pierson, 222 N. Y. Supp. 532 (Sup. Ct. 1927).

[70] Rothermiller v. Stein, 143 N. Y. 581, 38 N. E. 718 (1894). But *cf. In re* Ebbet's Will, 276 N. Y. Supp. 567 (Surr. Ct. 1934).

ing the condition of the corporation and the value of the shares.[71] This rule that a director is as free as is a stranger to buy the stock of his fellow shareholder, and so need not disclose the facts he knows with reference to the company's condition and plans, has been adopted in a number of other states.[72]

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[71]Bd. of Commissioners of Tippecanoe County v. Reynolds, 44 Ind. 509 (1873).

[72]Stout v. Cunningham, 33 Idaho 464, 196 Pac. 208 (1921), wherein the general manager and a director purchased stock for $200,000 at a time when they had a contract with another to sell it to him for $250,000; Perry v. Pearson, 135 Ill. 218, 25 N. E. 636 (1890), both parties were directors and equally familiar with the facts, and the buyer was convinced the seller was trying to cheat him; Hooker v. Midland Steel Co., 215 Ill. 444, 74 N. E. 445 (1905), wherein the selling shareholder did not rely upon the buying director, having become convinced that the director had falsely answered his former inquiries, so that the shareholder employed an attorney to investigate the corporation's standing; Waller v. Hodge, 214 Ky. 705, 283 S. W. 1047 (1926), wherein the seller had been a director until shortly before the sale, he having resigned to join the army, and thereafter the business had prospered, but the value of the stock continued to be a matter of speculation, and the buying director told the stockholder that no dividend would be declared but the profits would be distributed in salaries; Blabon v. Hay, 269 Mass. 401, 169 N. E. 268 (1929) wherein the selling stockholder wrote that he wished to sell and asked the prevailing market price, to which the director-secretary replied that he could sell the stock for $100 and that the directors would soon declare a dividend, and following extended correspondence of substantially the same nature, the shareholder sent his stock to the director with a draft attached, whereupon the director paid the draft and after failing to find another buyer took the stock himself and one year later sold it at a large profit; Walsh v. Goulden, 130 Mich. 531, 90 N. W. 406 (1902), wherein the director purchased stock and thereafter was able through its ownership to make a large profit on a contract he did not contemplate making when he bought the stock; Woodruff v. Cole, 307 Mo. 19, 269 S. W. 599 (1925), wherein the seller had been a director until shortly before the sale, knew all the facts, and opened the negotiations; Crowell v. Jackson, 53 N. J. L. 656, 23 Atl. 426 (1891), wherein the director bought knowing that the company had made a favorable sale of its property which enhanced the value of the stock, and knowing the selling shareholder to be ignorant of the sale; Connolly v. Shannon, 105 N. J. L. 155, 147 Atl. 234 (1929), wherein both parties were directors, but the buyer was negotiating for a sale of the business to another, which sale he knew was practically sure to be made at a price which would enhance the value of the stock, the seller knowing nothing of the plans, which were thereafter carried out; Carpenter v. Danforth, 52 Barb. 581 (N. Y. 1868), wherein the stock had a regularly quoted market price; Deaderick v. Wilson, 67 Tenn. 108 (1874), wherein the director availed himself of superior knowledge of corporate plans and prospects to buy shares from small shareholders at less than their real value; Shaw v. Cole Mfg. Co., 132 Tenn. 210, 177 S. W. 479 (1915), wherein the director bought without disclosing the book value of the stock, there being no special trust between the parties, and the director having no additional information which the stockholder did not have; Haarstick v. Fox, 9 Utah 110, 33 Pac. 251 (1893), wherein the seller opened the negotiations, and the director had no special knowledge; O'Neile v. Ternes, 32 Wash. 528, 73 Pac. 692 (1903), wherein the seller distrusted the director and knew the stock was worth more than the price offered, but accepted the offer because she needed money, she having opened the negotiations; Haverland v. Lane, 89 Wash. 557, 154 Pac. 1118 (1916), wherein the company was a telephone company and the director bought without disclosing his agreement with the Bell System under which he could dispose of the stock at a large profit.

The United States Supreme Court in the case of *Strong v. Repide*[73] announced what has come to be called the "Special Facts Doctrine." In that case Repide was not only a director, but also the sole person in charge of certain negotiations looking to the purchase by the government of substantially all of the corporation's property. The corporation had suspended active business, and the sole hope for any substantial payment to the stockholders lay in the prospects of the sale of its land in the Philippine Islands to the government. The decision upon the government's offer rested entirely with the defendant director. Being practically assured of selling to the government at a price which would yield a handsome return to the shareholders, Repide determined to buy the shares of Mrs. Strong, who had placed her stock in the hands of one Jones, who had an office adjoining the defendant's. The defendant knew that if he attempted in person to buy from Jones, the latter would suspect that the sale to the government was about to be consummated and would ask about the state of the negotiations. To avoid such embarrassing inquiry the defendant sent a broker to buy the stock. Thus, Jones did not know the identity of the buyer, and sold without asking about the negotiations. The court, conceding for the purposes of argument that there is no such fiduciary relation between the director and the individual shareholder as will in the ordinary case impose upon the director the duty of disclosing, without inquiry from the stockholder, all facts in the director's knowledge relating to the value of the stock before buying it, said that the circumstances surrounding this transaction were such that it was Repide's duty to disclose the state of the negotiations with the government. The special facts which the court found sufficient to give rise to this duty were: (1) Repide was not only a director but already owned three-fourths of the stock and was administrator-general of the company, (2) he was then engaged in negotiations which if successful would cause the stock to be worth much more, (3) he was in sole charge of the negotiations and the decision rested with him, (4) the negotiations were for the sale of the entire corporate property, or practically so, (5) he concealed his identity in buying so as to avoid questions. In considering the justice of setting aside the sale in this case, it should be borne in mind that Jones was a business man and not only did he know the negotiations were pending, but he knew also that the man in the office next to his could give him full information as to their progress, and yet he sold without making such inquiry. Had the stock belonged to Jones the decision might have been different, though the court does not so indicate. It would seem that Jones thought he was making a shrewd bargain and was afraid to make inquiry of Repide lest the supposed

[73] 213 U. S. 419 (1909).

buyer become suspicious and withdraw his offer. In all of these cases it is well to bear in mind that all of the crafty, unscrupulous men and women are not on boards of directors, and that many a poor stockholder will turn welcher when he finds himself caught in the trap of the man whose financial scalp he has been trying to lift. As between the welcher-stockholder and the trapper-director there is little to choose, and if Law is not cautious in its campaign to free the unwary stockholder from the trap of the unscrupulous director, it will find that it has delivered the innocent director into the hand of the welcher.

The "Special Facts Doctrine" appears to be the majority rule at present. Some courts have refused to set aside a sale of stock to a director on the grounds of no actual fraud and no duty to disclose, saying at the same time that under other circumstances a duty to disclose would rest upon the purchasing director.[74] A large number of cases may be found in which sales to directors were set aside, or the director held accountable to the seller for the profits realized, because of the special circumstances surrounding the transactions, the courts recognizing the rule that generally there is no duty to speak in the absence of inquiry.[75]

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[74]Steinfeld v. Nielson, 15 Ariz. 424, 139 Pac. 879 (1913); O'Brien v. O'Brien, 238 Mass. 403, 131 N. E. 177 (1921); Goodwin v. Agassiz, 283 Mass. 358, 186 N. E. 659 (1933); Seitz v. Frey, 152 Minn. 170, 188 N. W. 266 (1922); *cf.* McDermott v. O'Neill Oil Co., 200 Wis. 423, 228 N. W. 481 (1930); Hacker v. Kyle, 211 Wis. 584, 248 N. W. 134 (1933); Percival v. Wright [1902] 2 Ch. 421.

[75]Buckley v. Buckley, 230 Mich. 504, 202 N. W. 955 (1925), wherein the corporation was a small family affair, the parties brothers, and the director on inquiry gave only the dark side of the picture; Gammon v. Dain, 238 Mich. 30, 212 N. W. 957 (1927), wherein the jury found that the dividend of 90%, for which the seller sued, was declared before the sale, and that this exceptional fact did not appear on the company's books; Lightner v. W. H. Hill Co., 258 Mich. 50, 242 N. W. 218 (1932), wherein the seller employed a broker to sell, instructing him not to inform anyone in the company of his intent to sell, which instruction the broker violated, colluding with the defendant director, who had refused to give the seller any information about the business; Backus v. Kirsch, 264 Mich. 339, 249 N. W. 872 (1933), wherein the director in offering to buy the stock of an aged man who was satisfied with his investment and inactive in business, falsely stated his motive in buying to be that he wished to retire and as he had organized the business he felt morally obligated to protect the plaintiff from loss incident to his retirement; Dutton v. Barnes, 162 Minn. 430, 203 N. W. 414 (1925), wherein the director induced the sale by doleful accounts of the business, incomplete if not false; Saville v. Sweet, 254 N. Y. Supp. 768 (App. Div. 1932), wherein the director bought from the administrator of the deceased founder of the small business, and deliberately misrepresented the recent earnings of the company; Commonwealth Trust Co. v. Seltzer, 227 Pa. 410, 76 Atl. 77 (1910), wherein the director's wholesale purchases and resale to another company, which was thereby seeking to acquire the corporate property, were treated as amounting to a sale of property of the corporation, resulting in a secret profit to the director, and so a wrong to the corporation itself; White v. Texas Co., 59 Utah 180, 202 Pac. 826 (1921), wherein the director, having contracted to resell the stock at a handsome profit, induced the sale to himself by a fearful story of impending failure of

The doctrine that without inquiry and in the absence of special circumstances the fact that the buyer is a director imposes upon him a duty to make full disclosure to the selling stockholder of all information affecting the value of the stock, received by him through his directorship, and not appearing on the company's books was first announced by the Georgia Court.[76] The court calls the director a quasi-trustee for the individual shareholder as to his stock, and his knowledge a quasi-asset of the company. The court said: "Having previously trusted the director in the management of the company, he [the stockholder] is not required, when selling his shares, suddenly to exhibit entire want of confidence." It is submitted that one usually trusts the manager of his business to protect him in dealings with customers, but when the manager offers to buy the business the employer no longer expects the manager-offeror to tell him what it is worth, nor to tell him any more than he expects any other friend making such offer to tell him. When the manager appears in the role of a buyer of the business, the employer deals with him at arm's length. If this criticism of the quotation from the opinion is justified, the whole doctrine of a general duty to disclose falls to the ground.

The Georgia Rule has been followed by a substantial minority of the states.[77] Of the cases adopting the Georgia Rule the two

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the company, the seller being his personal friend and having implicit confidence in him; Voellmeck v. Harding, 166 Wash. 93, 6 P. (2d) 373 (1931), wherein the buying director threatened to discharge the seller, who was also an employee, unless he accepted the director's offer, and also misrepresented to the seller the effect on his stock of a proposed sale of the business; Poole v. Camden, 79 W. Va. 310, 92 S. E. 454 (1917), wherein the director bought through an agent, who did not disclose his principal's identity, and the director on inquiry from the stockholder misrepresented the condition of the company; see Note to Percival v. Wright, 4 Br. Rul. Cas. 786, 792 (1902).

[76]Oliver v. Oliver, 118 Ga. 362, 45 S. E. 232 (1903).

[77]Dawson v. Nat'l Life Ins. Co., 176 Iowa 362, 157 N. W. 929 (1916); Stewart v. Harris, 69 Kan. 498, 77 Pac. 277 (1904), wherein the seller was eighty years of age and retired from active business, owned but a few shares in the bank, had never had experience in the banking business, and upon his inquiry the buying director told him the bad features of the corporation's condition, but withheld other facts showing the business had recovered from its previously shaky condition; Hotchkiss v. Fischer, 136 Kan. 530, 16 P. (2d) 531 (1932), wherein the seller, a widow whose stock came to her from her deceased husband, was in need of funds, and upon her inquiry the buying director did not make full disclosure of the facts bearing on the probability of the board's declaring a dividend, which the board did three days later to an amount nearly equal to the price the buyer-director paid for the shares; Macgill v. Macgill, 135 Md. 384, 109 Atl. 72 (1919), wherein the whole board conspired to induce the other stockholders to surrender their common stock for callable preferred, and then promptly called the preferred, leaving themselves the sole shareholders of a very prosperous business; Barbar v. Martin, 67 Neb. 445, 93 N. W. 772 (1903), wherein the seller, a woman, asked the director to help her sell the stock and he bought on his own account without disclosing such intent, having at the time a contract with a third party whereby he was enabled to resell immediately at a profit; Jacquith v. Mason, 99 Neb. 509, 156

Kansas decisions would certainly have been decided the same way under the "Special Facts" doctrine. The same is true of the South Carolina case, and the older Nebraska case, which should have been put upon ordinary principles of agency. If the second Nebraska case could not have been decided upon the special facts there present, which might have been possible, the decision was doubtless influenced by the former one. The Maryland case was not a purchase of stock by the director, but a conspiracy among the directors to divert to themselves the corporate profits by corporate dealing with the other shareholders, and so was a clear misuse not only of their information but of their power as the entire board of directors as well. One can but wonder if a little more industry on the part of the plaintiff's counsel in the two remaining cases—the parent case from Georgia and the descendant from Iowa — might not have brought to light special circumstances there.

Analysis of the facts in the cases supporting the Georgia Rule indicates that it is an error resulting from a commendable distaste for dishonorable conduct. It could be dismissed as such but for the fact that the rule has the support of nearly every textbook on Corporations, and apparently all but one of the law review articles and notes on the question.[78] However, those who favor the rule recognize that to apply such a doctrine to every purchase of stock by a director would result in injustice to the director in many cases. As a result, they advocate excepting from its operation purchases under special circumstances. Thus, it has been suggested that the rule should not be applied to purchases of stock which is dealt in upon the stock exchange, and so has an established market price.[79] Again, it has been suggested that the doctrine should not apply where the director's knowledge was of a fact generally known to the public, whether known to the selling shareholder or not, and

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N. W. 1041 (1916), wherein the buying director knew the seller was not familiar with public transactions, and did not inform him of the fact that a third party was buying all the outstanding stock that the director could get and at a much higher price; Black v. Simpson, 94 S. C. 312, 77 S. E. 1023 (1913), wherein the buying director made fraudulent misrepresentations that the company was financially embarrassed; *cf.* Smith v. Gray, 50 Nev. 56, 250 Pac. 369 (1926) (sale sustained on the ground that there was sufficient disclosure).

[78]BALLANTINE, CORPORATIONS (1927) § 125; CLARK, CORPORATIONS (3d ed. 1916) § 213; STEVENS, CORPORATIONS (1936) § 145; Wilgus, *Purchase Of Shares Of Corporation By A Director From A Shareholder* (1909) 8 MICH. L. REV. 267; Smith, *Purchase Of Shares Of A Corporation By A Director From A Shareholder* (1921) 19 MICH. L. REV. 698; Laylin, *The Duty Of A Director Purchasing Shares Of Stock* (1918) 27 YALE L. J. 637; Berle, *Publicity Of Accounts And Directors' Purchases Of Stock* (1927) 25 MICH. L. REV. 827; Notes: (1929) 28 MICH. L. REV. 449; (1930) 14 MINN. L. REV. 530; (1930) 39 YALE L. J. 582. *Contra*: Walker, *The Duty Of Disclosure By A Director Purchasing Stock From His Stockholders* (1923) 32 YALE L. J. 673.

[79]BALLANTINE, CORPORATIONS (1927) § 125.

that it should not be applied where the selling shareholder shows an indifference to unknown factors and has, himself, fixed the price at which he will sell.[80] Another writer insists that the rule should apply to stocks listed on exchanges, but that in such case it goes no further than to require that directors must assemble corporate data with ordinary business accuracy and publish with ordinary promptitude, whereupon the facts become as available to the stockholder through the machinery of newspapers and brokerage houses as they are to the director.[81] Thus, the Georgia Rule finds itself supplemented with a "special facts" exception. The distinction between holding that there is no duty to disclose unless there are special facts, and holding that there is a duty to disclose unless there are special facts would not be the turning point in many cases. The effect of the distinction seems to be confined to the burden of proof, and it is no hardship upon the plaintiff to require him to introduce enough evidence of special facts to take the case to the jury, after which the question of burden of proof is generally academic.

Most, if not all, of the cases which have come before the courts would have been decided the same way had the "Special Facts" doctrine of *Strong v. Repide*[82] been applied. In the majority of cases adopting the rule that there is no fiduciary relation and so no duty to disclose, it is obvious that there was no special reliance upon the director, but in fact the parties dealt as strangers would. In most of the cases following the Georgia Rule, the facts show positive misrepresentation or trust and confidence existing apart from the directorship.

The "Special Facts" doctrine permits the sale to stand unless there was active fraud or an unusual reliance upon the director by the shareholder. If the director has reason to believe that the shareholder with whom he is dealing is relying upon him to withhold no important bit of information, then Conscience condemns his buying without making such disclosure. This is also the rule of Law. The only disagreement arises over the problem as to when the director has reason to believe that he is relied upon by the shareholder. The minority rule has said, "Always, with a few exceptions." The "Special Facts" rule, which is undoubtedly the majority rule even if there is anything left of the old view that the director has absolute freedom, says, "Not unless there are special circumstances indicating such reliance." What facts are enough to indicate such special reliance must be determined in each case. For that, the rule has been criticized as causing uncertainty in the

[80] STEVENS, CORPORATIONS (1936) § 142.
[81] Berle, *supra* note 78.
[82] 213 U. S. 419 (1909).

law.[83] It is submitted that it does not do so. The rule is certain. It is that the sale will be set aside if the director had reason to believe the selling shareholder was relying upon the director to make a full disclosure, and the director failed to do so. Like any other rule of law, it does not operate until evidence of its violation is introduced. The special facts are but bits of evidence proving such reliance. Of course, the doctrine leads to different results in different cases, but the results vary because of varying evidence, not because of any uncertainty in the rule. Facts which may be considered as indicating such reliance would be the age, sex, business experience, and education of the stockholder, relation by blood or marriage between the stockholder and the director, friendship, former associations between them, and that the director was the aggressor in the transaction.

The source of the director's information should make no difference, though the duty to disclose is often confined to information acquired through the director's position. The trouble with this limitation to "inside" information, is that it is practically impossible to separate inside from outside information, and it is a rare case in which the two are not mixed together as the basis for the director's decision to buy the stock. Suppose a corporation has pending an important appeal, a favorable decision upon which is certain to cause the stock to rise in value. If a director knowing this goes to the courtroom on the day opinions are released, finds a favorable decision has been made, and thereupon rushes to the home of an aged widow, who lives in an isolated rural section and owns just a few shares, and without disclosure buys her stock for the price shown in the stock exchange report published in the morning newspaper, can it be questioned that he ought to be compelled to account to her for the profits he makes by reselling after the expected rise in the market price has occurred? The same illustration shows that the stock's being listed on the exchange will not always solve the problem. Generally there is no special reliance in the case of a sale of stock listed on the exchange, because the seller does not know the buyer and so cannot be said to have relied upon him to disclose unsolicited information. However, listed stock can be sold in a face-to-face transaction, and the facts known to the director may make the stock worth much more than the price quoted. The illustration also shows that the fact that the director's information is shared by the general public, actually or theoretically, does not solve the problem. The question is, did the selling shareholder trust the buying director, and did the buying director have cause to believe he was so relied upon? If so, it makes

[83] Smith, *supra* note 78; Note (1930) 14 MINN. L. REV. 530.

no difference that nobody else would have trusted him, nor does it matter that everyone else shared his information.

It is generally said that if the buying director concealed his identity, as by sending an agent to the stockholder, the sale may be set aside. Knowledge by the seller that the buyer is a director is certainly an important fact, but it is not a fact which works the same way in all cases. Certainly, if the seller does not know who the buyer is, the seller cannot impose any trust in the buyer and does not expect the buyer to tell him anything. In such case the seller is dealing at arm's length with the buyer. He is worsted in the encounter not because he trusted the buyer, but because the buyer's arms were longer. It is true that the buyer's arms grew to such length because of the nourishing effect of a directorship, and it will be said that now he should not use his great reach to strangle the people who made it possible for him to grow. It must be remembered that the selling stockholder probably did not take an active part in elevating the buyer to his directorship, and may have opposed his selection. Also, a large proportion of the sellers in stock exchange transactions are speculators and not investors, and so neither concern themselves with the selection of directors nor expect anyone to tell them anything affecting the value of the stock. Neither class of sellers is in a position of accusing the director of having bitten the hand that fed him. It is only where the director is known to be the buyer that there can be any such reliance upon his honor as will justify setting aside the sale. For this reason the decision in *Strong v. Repide*[84] seems erroneous, though the doctrine there announced is sound. On the other hand, where the seller knows the buyer is a director there is not the required reliance in every case. Business men expect a rise in the price of any stock when they learn that the directors of the company are buying it. The mere fact that a director approaches a business man of average mentality with an offer to buy the latter's stock, will cause the stockholder to make some inquiry. It is only in the very exceptional case that the stockholder can be said to have trusted the director to disclose information not requested.

The only criticism of the "Special Facts" doctrine is that the result of its application is uncertain. It is admitted that it has accomplished justice "in the individual cases decided under it."[85] When a rule has been in formal use for nearly thirty years and has done complete justice whenever applied it would seem that uncertainty of result caused by differences in the fact situations is not a sound reason for departing from it in favor of a rule which

[84] 213 U. S. 419 (1909).
[85] Smith, *supra* note 78; Note (1930) 14 MINN. L. REV. 530.

will frequently, to say the least, result in injustice, unless qualified by a "special facts" doctrine of its own, in which event some injustice will be eliminated but the uncertainty complained of will recur.

THE STATUS OF CHOSES IN ACTION OF DISSOLVED BUT UNADMINISTERED CORPORATIONS AFTER EXPIRATION OF THE STATUTORY PERIOD FOR WINDING UP

*Urban R. Miller**

A confusing question which has been further provoked by the past years of economic instability is the status of the credit assets of a firm which is continuing in business as a going concern after forfeiture of its corporate charter and without subsequent reorganization or administration of any kind. An example will illustrate the situation in which many firms which once exercised corporate powers may find their intangible assets.

In an action to collect a debt the plaintiff inadvertently alleged corporate status. Having been incorporated prior thereto, the plaintiff entered into the contract as a corporation. Subsequent, however, to the date of the contract the plaintiff's charter was forfeited for nonpayment of corporate franchise tax.[1] The laws of the state provide that a corporation shall exist for a specified time after dissolution in which to wind up its business. Thereafter the plaintiff, without a defined legal entity, continued in business as before. It used the same name and the same contract which erroneously recited that it was a corporation. No receiver was appointed; no formal distribution of assets was made; no partnership of the stockholders was formed. It had always a nominal number of stockholders, and they continued in the management of the business as during corporate existence.

This suggests a possible uncertain destiny for the choses in action of many small businesses today, if there is an incorporeal existence after the expiration of the statutory period for winding up the affairs of a dissolved corporation. Although stated partially in the abstract, these facts are more than hypothetical—they are real. For several years many of the smaller corporations have been faced with a serious struggle for existence. To keep the wolf from the door they cut expenses to the vanishing point. Along with other hitherto outlays for overhead went corporate franchise taxes. Some statutes provide that failure to perform certain duties automatically dissolves or suspends a corporation;[2] others make neces-

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[1] *Cf.* Guaga Iron Co. v. Dawson, 4 Blackf. 202 (Ind. 1836) (distinguishing between denial of corporate existence as of the date of the contract and denial as of a subsequent date).

[2] Brooklyn Steam T. Co. v. Brooklyn, 78 N. Y. 524 (1879); Four-S Razor Co. v. Guymon, 110 Kan. 745, 205 Pac. 635 (1922).

sary a formal judicial decree of dissolution.[3] But the mandate of automatic dissolution or suspension upon failure to pay annual franchise taxes is most common.[4] Under these circumstances, a corporation might easily have ignored its sovereign's notice that its entity had been forfeited and gone ahead as before, to all outward appearances the same corporation.

The question is largely moot as far as decisions squarely in point are concerned. Recently in a lower court the plaintiff apparently thought it wise to drop the matter when the defendant entered a plea in abatement. In future actions the defense may not be enterprising enough to look into the plaintiff's corporate status. It is in rare instances that counsel will bother to raise the question. Notwithstanding, with thousands of small businesses having emancipated themselves from the burden of corporate existence fees without further administration of any kind, the situation suggests a possibility of the impairment of otherwise sound credit assets.

Methods of Winding Up Subsequent to Dissolution

Procedure subsequent to dissolution depends upon whether there are statutory provisions. If there are none, resort must be had to a court of equity.[5] Statutory provisions generally set up one of the following methods for winding up: (1) continuance of the corporation's life for a definite or indefinite period for the purpose of winding up; (2) appointment of a statutory receiver; (3) recognition of officers or stockholders as statutory trustees for the purpose of winding up; and (4) vesting the property of certain types of corporations in the state as trustee. But only one method of winding up is available unless provided by statute.[6] After expiration of the statutory period of extended life further relief exists only in equity.[7]

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[3]People v. Washington Ice Co., 18 Abb. Pr. 282 (N. Y. 1865) (except in case of insolvency); Saunders v. Mecklenburg Bank, 112 Va. 443, 71 S. E. 714 (1911).

[4]Indian Protective Ass'n v. Gordon, 34 App. D. C. 553 (1910), *aff'd*, 225 U. S. 698, 56 L. ed. 1262, 32 Sup. Ct. 839 (1912) (Delaware statute construed); Aalwyn's Law Inst. v. Martin, 173 Cal. 21, 159 Pac. 158 (1916); American Surety Co. v. Great White Spirit Co., 58 N. J. Eq. 526, 43 Atl. 579 (1899); Klamath L'br. Co. v. Bamber, 74 Ore. 287, 145 Pac. 650 (1915); Hawley v. Bonanza Queen M. Co., 61 Wash. 90, 111 Pac. 1073 (1910).

[5]Mumma v. Potomac Co., 8 Pet. 281, 8 L. ed. 945 (1834); Life Ass'n v. Fassett, 102 Ill. 315 (1882); Mott v. Danville Seminary, 129 Ill. 403, 21 N. E. 927 (1889); Folger v. Chase, 8 Pick. 63 (Mass. 1836); Att'y Gen. v. Gower, 2 Mod. 224 (K. B. 1740); Hastings Corp. v. Letton [1908] 1 K. B. 378, 13 Ann. Cas. 574, 3 B. R. C. 617.

[6]St. Louis & S. Coal & Mining Co. v. Sandoval Coal & Mining Co., 111 Ill. 32 (1884).

[7]Mumma v. Potomac Co., 8 Pet. 281, 8 L. ed. 945 (1834); Life Ass'n v. Fassett, 102 Ill. 315 (1882); Att'y Gen. v. Gower, 2 Mod. 224 (K. B. 1740);

The Common-Law Rule

Before a plaintiff which brings suit in a corporate name after the expiration of the prolonged statutory period can correct its mistake, it must first be decided what became of its unadministered assets. It is universally settled by the common law authorities, and under the statutes, that it can no longer sue in its corporate name,[8] except under a statutory period of prolonged life for winding up. So, too, the weight of authority is that actions already commenced during the period for winding up abate,[9] unless by statute they are allowed to proceed to judgment nothwithstanding dissolution. In fact, the corporation no longer exists for any purpose, unless there is some statutory provision which continues its life.[10] Statutes generally limit those powers to acts necessary to wind up corporate affairs.[11] A similar rule is applied upon suspension for

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Hastings Corp. v. Letton [1908] 1 K. B. 378, 13 Ann. Cas. 574. 3 β. R. C. 617.

Two of the methods provided by statute are legislative restatements of equitable rules. These are the appointment of a receiver, and the vesting of the assets in corporate officers as trustees. So if one of these existing remedies is unavailable, equity purposes not an alternative remedy, but the same remedy. However, if an existing statutory period of extended life is unavailable, equity provides an alternative remedy.

Statutory provisions prolonging corporate life for winding up have been very aptly described as "embodiments of equitable doctrines" in Mason v. Pewabic Mining Co., 22 U. S. App. 685, 66 Fed. 391 (C. C. A. 6th, 1894).

[8]Ewen v. American Fidelity Co., 271 Fed. 848 (C. C. A. 2d, 1921); Sharp v. Eagle Lake L'br. Co., 90 Cal. App. 386, 212 Pac. 933 (1923); City Ins. Co. v. Commercial Bank, 68 Ill. 348 (1873); MacRae v. Kansas City Piano Co., 69 Kan. 457, 77 Pac. 94 (1904); Bonaffe v. Fowler, 7 Paige 576 (N. Y. 1839); Great American Ins. Co. v. Farmers' Whse. Co., 91 Okla. 118, 217 Pac. 208 (1923).

[9]Pendleton v. Russell, 144 U. S. 640, 36 L. ed. 574, 12 Sup. Ct. 743 (1892); Marion Phosphate Co. v. Perry, 74 Fed. 425 (C. C. A. 5th, 1896); Ewen v. American Fidelity Co., 271 Fed. 848 (1921); Harned v. Beacon Hill R. E. Co., 9 Del. Ch. 411, 84 Atl. 229 (1912); Venable Bros. v. Southern Granite Co., 135 Ga. 508, 69 S. E. 822 (1910); Clark v. American Cannel Coal Co., 165 Ind. 213, 73 N. E. 1083 (1905); Eagle Chair Co. v. Kellsey, 23 Kan. 632 (1880); Maine Shore Line R. R. v. Maine Central R. R., 92 Me. 476, 43 Atl. 113 (1899); Thornton v. Marginal Ry., 123 Mass. 32 (1877); Boston Tow Boat Co. v. Medford Nat. Bank, 288 Mass. 484, 117 N. E. 928 (1917); Bowe v. Minn. Milk Co., 44 Minn. 460, 47 N. W. 151 (1899); Miami Exporting Co. v. Gano, 13 Ohio 269; Great American Ins. Co. v. Farmers' Whse. Co., 91 Okla. 118, 217 Pac. 208 (1923); S. & W. L'br. Co. v. Sumpter Valley Ry., 81 Ore. 32, 152 Pac. 262 (1915); Gamer v. Gamage, 241 S. W. 736 (Tex. 1922); Lyon-Gray L'br. Co. v. Gibraltar Life Ins. Co., 247 S. W. 652 (Tex. 1922); Hawley v. Bonanza Queen M. Co., 61 Wash. 90, 111 Pac. 1073 (1910); Pabst v. Circuit Ct., 184 Wis. 301, 199 N. W. 213 (1924); Lynchburg Colliery Co. v. Gauley & E. R. R., 92 W. Va. 155, 114 S. E. 462 (1922); First Nat. Bank v. Colby, 21 Wall. 609, 22 L. ed. 687 (U. S. 1874); Agnew v. Bank, 2 Harris & J. 478 (Md. 1828); Cooper v. Oriental S. & L. Ass'n, 100 Pa. 402 (1882); Miller v. Newburg Orrel Coal Co., 31 W. Va. 836, 12 Am. St. Rep. 903, 8 S. E. 600 (1888).

[10]Merritt v. Gate City Nat. Bank, 100 Ga. 147, 27 S. E. 979 (1897); Clark v. American Cannel Coal Co., 165 Ind. 213, 73 N. E. 1083 (1905); Great American Ins. Co. v. Farmers' Whse. Co., 91 Okla. 118, 217 Pac. 208 (1923).

[11]Merges v. Altenbrand, 45 Mont. 355, 123 Pac. 21 (1912); Houston v. Utah, etc., Co., 55 Utah 393, 187 Pac. 174 (1919).

failure to pay a license tax.[12] This rule is extended by analogy and by statute to the period of extended life after dissolution.[13]

At common law debts owing by and to a corporation expired with the last breath of the corporation. That was the rule whether the destruction of the corporation was by abrupt premature dissolution or by the natural expiration of the charter period.[14] Real estate owned by the corporation reverted back to the grantors,[15] and the sovereign took remaining tangible personal assets.[16] And as far as the appearance of reason and logic is concerned, these courts might have been just as willing to apply the same rule upon the expiration of a statutory period of extended life for winding up.

Statutory Relief from Effect of the Common-Law Rule

Modern American Statutes

To relieve from this harsh rule, chancery has intervened or the states have established statutory *post-mortem* periods for winding up the affairs of dissolved corporations.[17] These statutes usually provide that no charter powers can be exercised after dissolution except those continued by law for the purpose of winding up the corporation's affairs.[18] Post dissolution periods ranging from two to five years are common;[19] while the most recently amended statutes provide that the corporation shall have a reasonable time in

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[12]Ransome-Crummey Co. v. Superior Ct., 188 Cal. 393, 205 Pac. 446 (1922).

[13]American Bonding & Cas. Co. v. Chicago Bonding & Ins. Co., 226 Ill. App. 475 (1922); Ewald Iron Co. v. Commonwealth, 140 Ky. 692, 131 S. W. 774 (1910); Houston v. Utah, etc., Co., 55 Utah 393, 187 Pac. 174 (1919); 7 Fletcher, Corporations §§ 5572, 5636.

[14]Mumma v. Potomac Co., 8 Pet. 281, 8 L. ed. 945 (1834); Life Ass'n v. Fassett, 102 Ill. 315 (1882); Folger v. Chase, 8 Pick. 63 (Mass. 1836); Att'y Gen. v. Gower, 2 Mod. 224 (K. B. 1740).

[15]Mumma v. Potomac Co., 8 Pet. 281, 8 L. ed. 945 (1834); Mott v. Danville Seminary, 129 Ill. 403, 21 N. E. 927 (1889); Hastings Corp. v. Letton [1908] 1 K. B. 378, 13 Ann. Cas. 574, 3 B. R. C. 617.

[16]*Ibid.*

[17]The following states have no statutory provisions to this effect: Arkansas, Colorado, Georgia, Idaho, Kansas, Louisiana, Minnesota, Missouri, Montana, Nebraska, North Dakota, Oklahoma, Pennsylvania, South Carolina, South Dakota, Washington, West Virginia, Wyoming.

[18]See note 11, *supra.*

[19]The following statutory periods of prolonged life for winding up are provided in the various states:

Two years: Illinois (but final certificate of dissolution is not issued until liquidation is completed), Indiana.

Three years: Delaware, Florida, Maine, Massachusetts, Michigan, Mississippi (except when liquidation trustees are appointed by the court), Nevada, New Hampshire, North Carolina (but in pending actions the court may extend the time), Rhode Island, Texas (except when receiver is appointed by a court, in which instance *quasi*-corporate life continues until liquidation is completed), Virginia, Vermont, Wisconsin.

Five years: Alabama (except when dissolution is by judicial decree), Oregon.

which to wind up its affairs.[20] During this extended period the corporation can sue and be sued in its corporate name, and can use its entity only to wind up its existing affairs.[21] However, in employing dissolution proceedings as a penalty for failure to pay the tax, frequently the state is not interested in a receivership, except in the case of banks, insurance companies and other financial institutions. This must be demanded by interested parties, and therefore becomes a significant fact.

But suppose the stockholders are averse to assuming the trouble and expense of a formal liquidation of the corporate affairs. This is a usual attitude. A liquidation process or a change in ownership or entity often begets unfavorable and misunderstood publicity. For like reasons formal reorganization is avoided. Were its credit assets destroyed? Or may the temper of the modern rule of statute designed to dilute the stringency of the common law rule be extended by construction to the time after expiration of the statutory period? Or is the effect of this saving rule confined to the statutory period for winding up, and relief thereafter possible only by the grace of the legislature?

The common law did not recognize any right in the stockholders to the assets of the dissolved corporation, regardless of the time and cause for dissolution.[22] Since the statutes are expressly for the purpose of relieving from the effect of the common law rule, relief *aliunde* must be the product of chancery. But how long is such statutory relief available? On principles of statutory construction only during the period specified in the law itself.[23]

The Modern English Rule

While a solution to the questions discussed herein may be suggested by a group of cases which tend to a doctrine that where the common law rule has been modified by statute, there is indicated an intent to prevent the extinction of corporate property rights,[24] a

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[20]Arizona (in cases of voluntary dissolution and expiration of charter), California, Connecticut, Iowa, Kentucky, Maryland, New Jersey, New York, Ohio, Tennessee, Utah.

[21]Salem Bank v. Caldwell, 16 Ind. 469 (1861); Saunders v. Mecklenburg Bank, 112 Va. 443, 71 S. E. 714 (1911).

[22]See notes 4 and 5, *supra*.

[23]Taggart v. Perkins, 73 Mich. 303, 41 N. W. 426 (1889); Rockwith v. State Road Bridge Co., 145 Mich. 455, 108 N. W. 785 (1906).

[24]Herron v. Vance, 17 Ind. 595 (1861); Cunningham v. Clark, 24 Ind. 7 (1865); McCarthy Co. v. District Ct., 201 Iowa 912, 208 N. W. 505 (1926), in which the court, construing a statute prolonging the existence of a corporation for winding up, said that such provisions "are intended to enable corporations to dispose of their assets to wind up their affairs without the intervention of a receiver, unless the appointment thereof should be necessary to preserve the assets, make disposition thereof, and to conserve and protect the interests of the creditors and stockholders." Castle v. Acrogen Coal Co., 145 Ky. 591, 140

more unambiguous solution is within the realm of practicability. That is a statutory restatement of the modern English rule that dissolution is not effective until after consummation of the winding-up process.[25] An unlimited statutory period for winding up is practically the same thing.[26]

It may still be contended, however, that in a jurisdiction committed to this rule the question of the status of choses in action remaining uncollected at the time of the issuance of the final certificate of dissolution is an open one. Then arguing from this premise it may further be contended that since the time for final dissolution is under the control of the beneficiaries of the corporate estate, their act in allowing the issuance of this certificate would indicate an abandonment of uncollected choses. Adopting this conclusion, it is therefore doubtful whether they would thereafter be entitled to equitable relief. A milder form of this question came before the Illinois court during the later development of the present rule. It was accordingly resolved that there could not be an abandonment of assets to the fate of a wastrel administration during the statutory period for winding up that would preclude the appointment of a receiver.[27] An extension of the rule to prevent the destruction of credit assets by abandonment upon the lapse of the statutory period may be predicated upon the logic and analogy of this case.[28]

S. W. 1034 (1911); Crease v. Babcock, 23 Pick. 334, 34 Am. D. 61 (Mass. 1910); Nudelman v. Thimbles, 225 Mo. App. 553, 40 S. W. (2d) 475 (1931); Grey v. Newark Plank Road Co., 65 N. J. L. 603, 48 Atl. 557 (1901). However, the two Indiana cases, *supra*, are of doubtful value in this respect, since that jurisdiction is committed to the common-law rule of total destruction of credit assets upon expiration of the statutory period of extended life.

For a discussion of the attitude of the courts of various countries toward the status of assets of Russian corporations nationalized by the Soviet Government, see Hudson, *Recognition of Foreign Governments and Its Effect on Private Rights* (1936) 1 Mo. L. Rev. 312, 317 *et seq.* The writer suggests that the courts very generally, both here and abroad, have relaxed on application of rules of law, public policy and comity in order to prevent extinguishment of corporate assets by nationalization.

[25]Hastings Corp. v. Letton, [1908] 1 K. B. 378, 13 Ann. Cas. 574, 3 B. R. C. 617; Companies Act of 1862; Companies Act of 1908. Similar provisions are found in the corporation laws of Connecticut, Illinois, Louisiana and Minnesota.

[26]See provisions on the subject in the codes of the states listed *supra*, note 20. These provide for a prolonged period of corporate life for liquidation, but do not set a limit to the time.

[27]Midland Co. v. Anderson, 63 Ill. App. 51 (1895).

[28]It would be speculative to say that Illinois statutory provisions up to the time of the adoption of the English rule combined to abrogate the common-law doctrine as developed by Life Ass'n v. Fassett, 102 Ill. 315 (1882); City Ins. Co. v. Commercial Bank, 68 Ill. 348 (1873); Mott v. Danville Seminary, 129 Ill. 403, 21 N. E. 927 (1889); Keokuk & H. Bridge Co. v. Wetzel, 228 Ill. 253, 81 N. E. 864 (1907); Central S. & G. Co. v. Pine Tree L'br. Co., 140 Ill. App. 471 (1908). But the doctrine underwent modification by a progressive series of statutes. The Corporation Act of 1933 follows the modern English doctrine and provides that before a certificate of dissolution is issued a corporation shall perform all acts necessary to liquidation.

Judicial Modification of the Common-Law Rule

Popular reactions of the bar to the questions involved are (1) that the stockholders continue to conduct the business and hold the assets as partners or as a corporation *de facto*, or (2) that the stockholders have an absolute indefeasible equitable interest in the assets.

The Partnership Doctrine

The doctrine of a partnership relation between the stockholders of the defunct corporation was most definitely invoked in *Ewald Iron Company v. Commonwealth.*[29] The Kentucky statute provided that after dissolution a corporation could continue to do business for a reasonable time for the purpose of winding up. Construing this provision, the court held that during this period the stockholders who had disregarded the statutory command to wind up were doing business as partners. Directly to the contrary, however, is *Commercial Nat. Bank v. Gilinksy*[30] which held that the forfeiture of a corporate franchise and the continuation of the business in the corporate name did not create a partnership of the stockholders. The basis for the decision was that to constitute a partnership there must be some agreement by the parties. It has been held elsewhere that in the absence of statute, dissolution does not convert the stockholders into partners.[31] So under the usual prohibition against the defunct corporation engaging in business other than that necessary to wind up, it has no power to form a new company.[32] And under a statutory privilege to extend corporate life beyond the charter period by taking certain outlined steps during corporate existence, the required procedure taken after expiration of the period was ineffective to revive the corporation.[33] While in a recent Georgia case it was held that where a corporation continued with the corporate business after expiration of its char-

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[29]140 Ky. 692, 131 S. W. 774 (1910), construing Ky. Stat. § 561 (Russell's Stat. § 2147).

[30]142 Iowa 178, 120 N. W. 476 (1909).

[31]Tarbell v. Page, 24 Ill. 46 (1860); Central Savings Inst. v. Walker, 5 Hun 34 (N. Y. 1875).

None of these cases suggest whether a sound distinction can be drawn between the application of the partnership doctrine to existing assets and liabilities at the time of dissolution, and to the incidents of the business transacted by the defaulting stockholders after dissolution or after expiration of the statutory period of prolonged life. If a solution is predicable upon the partnership doctrine, consistency in reasoning would ignore any distinctions founded upon the prohibition of a retroactive application of the law in establishing the relationship.

[32]Mason v. Pewabic Mining Co., 25 Fed. 882 (W. D. Mich. 1885), *aff'd*, 122 U. S. 50, 33 L. ed. 524, 10 Sup. Ct. 234 (1890).

[33]Merges v. Altenbrand, 45 Mont. 355, 123 Pac. 21 (1912).

ter it was liable upon its contracts as a corporation *de facto*,[34] the rule is to the contrary in other jurisdictions.[35] And so there is conflict of authority on the question whether either the corporation or the one contracting with it is estopped from defending by a denial of corporate existence.[36]

The Equitable Trust-Fund Doctrines

In abrogation of the common-law doctrine is the modern rule that after dissolution the property and assets of the corporation are preserved in equity for the benefit of those entitled to share in them as creditors and stockholders.[37] The import of this rule is that it applies to all choses in action accruing during lawful exist-

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[34]Hall v. Kimsey, 173 S. E. 437 (Ga. App. 1934). *Cf.* CALIF. CIV. CODE (1933) §§ 345, 399, wherein corporate liability is preserved although the directors exceed their authority in winding up.

[35]Venable Bros. v. Southern Granite Co., 135 Ga. 508, 69 S. E. 822 (1910); Clark v. American Cannel Coal Co., 165 Ind. 213, 73 N. E. 1083 (1905); Meramec Spring Park Co. v. Gibson, 268 Mo. 394, 188 S. W. 179 (1916); Knights of Pythias v. Weller, 93 Va. 605, 25 S. E. 891 (1896).

[36]Kurtz v. Paola Town Co., 20 Kan. 397 (1878); Citizens' Bank v. Jones, 117 Wis. 446, 94 N. W. 329 (1903).

[37]Mumma v. Potomac Co., 8 Pet. 281, 8 L. ed. 945 (1834); Church of Latter-Day Saints v. United States, 136 U. S. 1, 10 Sup. Ct. 792, 34 L. ed. 478 (1880) (construing, however, the effect of dissolution upon a charitable corporation); Stearns Coal & L'br. Co. v. Van Winkle, 221 Fed. 590, 137 C. C. A. 314 (6th, 1915); Wonder Bakeries Co. v. United States, 6 F. Supp. 223 (Ct. Cl. 1934); Aalwyn's Law Inst. v. Martin, 173 Cal. 21, 159 Pac. 158 (1916); North Hollywood Mortg. Co. v. North American Bond & Mortg. Co., 30 P. (2d) 446 (Cal. 1934); Muscatine Turn Verein v. Funck, 18 Iowa 469 (1865); Pontiac Trust Co. v. Newell, 266 Mich. 490, 254 N. W. 178 (1934); People v. O'Brien, 111 N. Y. 1, 18 N. E. 692 (1888); Great American Ins. Co. v. Farmers' Whse. Co., 91 Okla. 118, 217 Pac. 208 (1923); Baldwin v. Johnson, 95 Tex. 85, 65 S. W. 171 (1901); Greenbrier L'br. Co. v. Ward, 30 W. Va. 43, 3 S. E. 227 (1887). But *cf.* Atty. Gen. v. Fidelity L. & T. Co., 113 Iowa 439, 85 N. W. 638 (1901).

The doctrine has been widely embodied in statutory provisions. The following is a classification of the various statutes on this phase of the subject:

Constituting Officers or Directors Trustees of Assets without Necessity of Judicial Appointment: Alabama, California, Colorado, Connecticut, Idaho, Kansas, Michigan, Missouri, Montana, Nebraska, Nevada, New Jersey, New York, North Carolina, North Dakota, Ohio, Oklahoma, Pennsylvania, South Carolina, South Dakota, Tennessee, Texas, Washington, Wisconsin, Wyoming.

Court Shall Appoint Liquidators from Stockholders: Delaware, Louisiana, Maryland.

Court Shall Appoint Liquidators from Disinterested Persons: Iowa.

Court May Appoint Receiver Either from Stockholders or Disinterested Persons: Georgia, Massachusetts, Minnesota, Rhode Island, West Virginia.

Corporate Assets Vested in State as Trustee: Arkansas.

Stockholders Hold Assets as Tenants in Common: Georgia, Maine, Mississippi.

No Statutory Provisions for Appointment of Receiver: Arizona, Florida, Indiana, Illinois, Kentucky, New Hampshire, Oregon, Utah, Vermont.

In Virginia the directors are made trustees at the end of the three year statutory period of prolonged life if liquidation has not been completed. VA. STAT. (1936) §§ 3810, 3813.

ence of the corporation.[38] But it has been narrowed by refinement to hold that the rule that a dissolved corporation can neither sue nor be sued, and all actions commenced against it abate absolutely and cannot be revived, applies only to actions at law.[39] The weight of justice is on the side of this rule.[40] It is amply supported by Chancellor Kent[41] and Justice Story.[42] In the absence of statutory enactments detracting from the theory of unimpaired equitable rights and remedies, it would be recognized as a fundamental American principle.[43]

But none of these cases construe the effect of an intervening statutory period for winding up and its actual negligent lapse. Apparently that method of winding up was not present in any statutes

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[38]People v. O'Brien, 111 N. Y. 1, 18 N. E. 692 (1888).

[39]Kelly v. Rochelle, 93 S. W. 164 (Tex. 1906).

[40]It is significant that the majority of the cases are concerned largely with capacity of the defunct corporation and not with equitable rights of stockholders. Many references to the latter are *obiter*. The present recognition of it is a principle of equity which has been evolved with the commonness of moneyed corporations and a more responsible attitude toward their property rights. The preservation of corporate property rights is necessary to the preservation of innumerable individual rights amassed into public rights.

[41]"The rule of the common law has in fact become obsolete and odious. It never has been applied to insolvent or dissolved moneyed corporations in England. The sound doctrine now is, as shown by the statutes and judicial decisions, that the capital and debts of banking and other moneyed corporations constitute a trust fund and pledge for the payment of creditors and stockholders, and a court of equity will lay hold of the fund and see that it is duly collected and applied. The death of a corporation no more impairs the obligations of contracts than the death of a private person." 2 KENT, COMM. *307, n. (b).

Chancellor Kent's views were quoted with approval by the Wisconsin Supreme Court in Lindemann v. Rusk, 125 Wis. 210, 104 N. W. 119 (1905). However, this action, commenced in equity within the three years allowed by statute for winding up, was not prosecuted to judgment until after expiration of the period. So it was merely held that the pending action could be continued to judgment thereafter. The adoption of Chancellor Kent's doctrine was therefore *dictum* as far as the specific question discussed herein was involved.

[42]"If a corporation is dissolved, the contracts of such corporation are not thereby deemed extinguished, but they survive the dissolution of the corporation, and the creditors may enforce their claims against any property belonging to the corporation, which has not passed into the hands of a *bona fide* purchaser; for such property will be held affected with a trust primarily for the creditors of the company, and, subject to their right, secondarily for the stockholders in proportion to their interests therein." STORY, EQUITY JURISPRUDENCE (14th ed.) § 1660.

[43]From the standpoint of history it is plausible that Chancellor Kent and Justice Story referred to the earlier American equitable doctrine of status applied to the assets of defunct corporations and unaffected by the existence of a period for winding up. The Tennessee Supreme Court suggested this qualification in O'Connor v. Memphis, 6 Lea 730 (Tenn. 1881). And that was after it had been committed to the common-law rule by the decision in White v. Campbell, 5 Humph. 38 (Tenn. 1844), that it could not recognize the existence of stockholders of a defunct corporation even in the face of an admission by a litigant that he was indebted to the defunct corporation. It is also significant to note that Chancellor Kent literally restricted the application of his doctrine to banking and moneyed corporations.

under consideration, except in the *Stearns* case.[44] Thus the following pertinent questions were not propounded: Under the operation of a statutory period for winding up, when do the shareholders or equitable trustees come into possession of their post dissolution rights? Upon formal dissolution? Or after the expiration of the statutory period? Or do they take at all if there has been no formal transfer of assets to them during the statutory period?

So in a discretionary judicial application of the trust-fund doctrine, we are confronted with an inevitable discrepancy. The fact that such a statute would otherwise be a purposeless piece of legislation was not argued. In the cases cited the question of the relative weight of legal and equitable remedies, other than the common law rule opposed by equity, went unsolved except by *obiter,* in all but the one case.[45] Here a federal court decided that the legal title to the property of a defunct corporation passed by operation of law to the stockholders, although there was a statute providing that a dissolved corporation may continue for the purpose of closing up its business. This court, however, was unwilling to rest the decision wholly on equitable principles, but said the transition was by operation of law—statutory law. So what interpretation will be given the scope and purpose of the statutory period of extended life when coincident with equitable preservation we cannot anticipate from this case.

Related Problems and Analogies

Abatement of Actions

While there is authority that an action commenced before dissolution may be prosecuted to judgment afterwards,[46] the greater

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[44]Stearns Coal & L'br. Co. v. Van Winkle, 221 Fed. 590, (C. C. A. 6th, 1915).

[45]*Ibid.*

[46]Dundee M. & T. Investment Co. v. Hughes, 89 Fed. 182 (C. C. Ore. 1898); Singer & Talcott Stone Co. v. Hutchinson, 176 Ill. 48, 51 N. E. 622 (1897); Graham & Morton T. Co. v. Owen, 165 Ill. App. 100; Franklin v. Cooper, 36 Me. 179, Lindemann v. Rusk, 125 Wis. 210, 104 N. W. 119 (1905).

The following provisions are found in the various codes with reference to abatement of actions upon dissolution:

No Abatement of Actions Pending Against the Corporation: California, Indiana, New Jersey, Texas.

No Abatement of Actions Pending By or Against the Corporation: Delaware, Idaho, Michigan, Nebraska, Nevada, North Carolina, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Virginia, Wyoming.

No Abatement for Specified Time Thereafter: Massachusetts (for sixty days after expiration of the three year period).

No Statutory Provisions on Subject: Alabama, Arizona, Arkansas, Colorado, Connecticut, Florida, Georgia, Illinois, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Minnesota, Mississippi, Missouri, Montana, New Hampshire, New York, North Dakota, Oregon, Pennsylvania, South Carolina, Utah, Vermont, Washington, West Virginia, Wisconsin.

weight of common law authority is to the effect that all actions pending at the time of dissolution abate.[47] As a corollary, the conclusion is inescapable that abatement of the action takes place only outside the statutory period of extended life—when there is no longer such a period. Anomalously this abatement occurs when the theory of the equitable rights of the stockholders comes most plainly into view—when there is greatest need for protection by the intervention of equity.

Abatement is a destruction of legal remedy or suspension of equitable remedy.[48] At law if the defect is not subsequently cured it becomes absolute and therefore a bar.[49] If the entity through which a stockholder takes an equitable right to a chose in action allows the negligent lapse of the period during which by action at law the corpus of that chose can be reduced to possession, can the stockholders then ask a court of equity to revive the action in him? If his equitable right is a prior and continuing right, and yet unusable until revival after abatement at law, we have an anomaly which only confuses the question: What is the purpose of the circuitous route of legal abatement and equitable revival? Would it not better appear that the right to equitable restoration is open only to the stockholders who can show that the legal right in the corporation did not expire *from some other cause* while the corporation was alive?[50]

Revival of Actions and Substitution of Parties

The theory of abatement brings up the question of revival of the action and substitution of parties. Strong authority allowing the direct substitution of another party, except a judicial receiver, for the defunct corporation, is "conspicuous by its absence." In a California case in which the underlying principles were discussed it was held that where a corporation was dissolved pending an action against it, the directors as trustees could be substituted as parties defendant only after they had been served with original process.[51]

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[47]See note 9, *supra*.

[48]Murphy v. Missouri & Kansas L. & L. Co., 28 N. D. 519, 149 N. W. 957 (1914); STORY, EQUITY PLEADING 354.

[49]*Contra*: Spring v. Webb, 227 Fed. 481 (Vt. 1915) (disputing the existence of such a rule in equity).

[50]The rule of abatement of pending actions upon the death of a corporate party is more absurd when it is compared with the decisions that a cause of action against an officer of a corporation may survive his death [Lee v. Fish, 222 Mass. 424, 109 N. E. 835 (1915)], and that an action or cause of action against a stockholder may survive his death [Koch v. Val Verde Merc. Corporation, 4 S. W. (2d) 662 (Tex. Civ. App. 1928)].

[51]Nezick v. Cole, 43 Cal. App. 130, 184 Pac. 523 (1919). Accord: Venable Bros. v. Southern Granite Co., 135 Ga. 508, 69 S. E. 822 (1910). *Contra*: Oberndorfer v. United States, 65 Ct. Cl. (F) 376 (1929); Marsh Wood Prod. Co. v. Babcock & W. Co., 207 Wis. 209, 240 N. W. 392 (1932).

This decision was in marked contrast to what we should have expected under the California statute which provided for the winding-up process by the officers of the corporation or liquidators appointed by the court.[52]

So in this case, under a statutory embodiment of the equitable doctrines exclusively, the California court drew a precise distinction between the corporate identity and that of the directors and managers. It indicated the necessity of more than revival of the action in the directors comparable to revival in the personal representatives of a deceased person. This means an entirely new action. As a result, does not the remedy of a defunct corporate plaintiff during a statutory period of prolonged life exist solely in the corporation's own right and by virtue of this statutory period of extended life? Can the directors and stockholders so removed from an identity with the corporation take up a right of action within the statute of limitations? Can the stockholders, themselves or through their agents, stand by and see their remedy at law extinguished by lapse of time and then ask a court of equity to grant them relief? After expiration of the statutory period for winding up there is no color of law for further activity, either by the corporation or one acting for it.[53]

To preclude a distinction between the stockholders and the corporation with respect to rights and liabilities after dissolution similar to the distinction enunciated in *Nezick v. Cole*[54] seems to have been in the contemplation of the Georgia court in construing a statutory provision in *Moultrie v. Smiley*.[55] It was held that dissolution did not abate an action to enforce a statutory personal liability against the corporate directors. By positive enactment the legislature preserved a liability which the courts of that jurisdiction would otherwise have been obliged to disregard under the tenets of subsequent decisions.[56]

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[52]The requirement of certainty specified by this short-sighted decision may have prompted an amendment to the California code, so that now a dissolved corporation may continue indefinitely for the purpose of winding up. CAL. CIV. CODE (1933) § 400.

[53]Commentators have disagreed upon the attributes of the corporate entity theory, to the extent of invoking hairsplitting philosophies. However, two practical rules are in judicial use. Applying the one—that a corporation aggregate is an association of individuals—the courts have looked beyond the corporation to the stockholders and have merged them and the corporation into one identity. Applying the other, they have segregated the identity of the stockholders from the corporate entity. Relief may be predicated upon the absence of fiction from the former.

[54]43 Cal. App. 130, 184 Pac. 523 (1919).

[55]16 Ga. 289 (1854).

[56]Merritt v. Gate City Nat. Bank, 100 Ga. 147, 27 S. E. 979 (1897); Venable Bros. v. Southern Granite Co., 135 Ga. 508, 69 S. E. 822 (1910).

By *dictum* the courts have referred to the possibility of the substitution of a receiver for a dissolved corporation,[57] and of an individual who succeeded to rights of the corporation.[58] It would seem, however, that with respect to rights of one not a receiver, the preliminary question of the existence of the essential facts warranting a substitution of a party plaintiff throws an insurmountable obstacle in the way. This is that proof must be presented that a prior assignment was made[59] for a valuable consideration.[60] Ironically, such proof is impossible once the action has been commenced in the corporate name.

Transfer or Assignment of Chose in Action Prior to Dissolution

Upon dissolution a chose in action may be transferred by the corporation.[61] In *Service & Wright Lumber Company v. Sumpter Valley Railway Company*[62] the Oregon court said that during the liquidation period the dissolved corporation could have assigned its cause of action to some person for the benefit of the stockholders. Not having done this, the right of action was impaired. During this appeal, however, the stockholders as equitable owners were substituted as parties and the cause was reinstated. In view of the inconsistency in the majority opinion, the logical rule is contained in the dissenting opinion. Here it was contended that since no title to the corporation's choses in action was acquired by interested parties during the five year period and while the corporation was alive to transmit it, thereafter no right to maintain the suit existed in anyone.

The Corporate-Entity Theory and the Estate Analogy

The situation is comprehended in no logical analogy to the administration of the estates of individuals. Statutes of descent and distribution route the course of property, both real and personal, of an intestate decedent into the hands of proper distributees, even through a period of abeyance during which there is no beneficiary in sight. However, in a study of the questions involved, attention is directed to such a reconciling analogy.[63] But is it sound? It is

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[57]Pendleton v. Russell, 144 U. S. 640, 36 L. ed. 574, 12 Sup. Ct. 743 (1892).

[58]Anderson v. Doral, 211 S. W. 80 (Mo. 1919); Pabst v. Circuit Ct., 184 Wis. 301, 199 N. W. 213 (1924).

[59]Boston Tow Boat Co. v. Medford Nat. Bank, 288 Mass. 484, 117 N. E. 928 (1917).

[60]Fish v. Smith, 73 Conn. 377, 47 Atl. 711 (1900).

[61]Salem Bank v. Caldwell, 16 Ind. 469 (1861).

[62]81 Ore. 32, 152 Pac. 262 (1915).

[63]Pontiac Tr. Co. v. Newell, 266 Mich. 490, 254 N. W. 178 (1934). Upon a rehearing of Ewald Iron Co. v. Commonwealth, 142 Ky. 465, 134 S. W. 481 (1911), the court extended its former opinion rendered in 140 Ky. 692, 131 S. W. 774 (1910). It was held that where a statute continued a dissolved cor-

unquestioned that a suit abates upon the death of a party, whether human or corporate. Upon the death of a human party during an action the function of abatement is to withhold the proceedings until a personal representative is endowed with power to sue or defend, pending the recognition of a right in the heir. This may never occur. However, if stockholders' existing and continuing equitable rights to assets authorize them to take up the suit upon the death of the corporate party, why the necessity of a break by abatement?[64] Why not a substitution instead of abatement and subsequent revival? The legal right of a personal representative or an heir or distributee is dependent upon the enactment and application of positive law. The equitable right of a stockholder is the product of judicial conscience, which in modern jurisprudence is just as fundamentally the basis of law and justice. Abatement therefore appears to be out of place in the latter instance.[65]

The Franchise Analogy

A more sound analogy is found in the law as to the lack of power in a dissolved corporation to continue thereafter in the ownership of public utility franchises. A utility franchise is as intangible a thing as a chose in action. It is not, however, in a legal, equitable or constitutional sense surrounded with the bilateral sanctity which pervades private contractual obligations. The body politic is inherent with the power to grant, withhold or forfeit a utility franchise; the public is interested, not as grantee of the privilege, but as grantor. And yet with due regard to these considerations of the nature of a utility franchise grant, our highest court

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poration for the purpose of winding up, but failed to limit the period, the court will follow the analogy of the statute relating to estates of decedents and limit the period for winding up to two years, the same as in estates of decedents.

[64]But *cf.* Spring v. Webb, 227 Fed. 481 (Vt. 1915) (an action held not to abate upon the death of a stockholder suing on behalf of the corporation).

[65]A contrary view to that expressed by the Kentucky Court in Ewald Iron Co. v. Commonwealth, 140 Ky. 692, 131 S. W. 774 (1910), 142 Ky. 465, 134 S. W. 481 (1911), is discussed in a very scholarly way in U. S. Radiator Corp. v. State, 208 N. Y. 144, 101 N. E. 783 (1913). This court went more thoroughly than the Kentucky court into the philosophy of the nature of a stockholder's rights in the corporation. After reviewing the rule that a stockholder's rights are created by the action, expressed through the medium of the stock certificate, of the corporation and the stockholders, the court said: "While conditions may exist under which equity will consider the shareholders as the proprietors and the ultimate beneficiaries of the corporate interests, the fact is that a corporation is an individual being incapacitated [capacitated] through statutory powers to acquire the title to, own, and dispose of real and personal property, enter into contracts, engage in business, sue and be sued and taxed. It is the owner of all the corporate property, real and personal, and within the powers conferred upon it by charter can deal with it as absolutely as a private individual can with his own. The whole title to it is in the corporation and the shareholders are neither tenants in common nor in any legal sense the owners of it. . . A shareholder cannot acquire title to any of the property of the cor-

has held that it is an asset of the estate of a dissolved corporation.[66] A contrary result, however, is announced in a line of decisions resulting from judicial construction of toll road franchises held by corporations and a consequent carry over of the doctrine to transportation franchises.[67] The basis for these decisions is not that a franchise is an intangible and seasonably destructible thing, but that it is property which the state can repossess and then regrant for the unexpired portion of its life.

These latter decisions are founded upon a weak premise. The analogy between a debt owing to a corporation and corporate ownership of a utility franchise is more rational than the analogy between a corporation and a human being. The former is predicated upon the nature of the thing owned; the latter is based upon human rights transferred by arbitrary law to an artificial entity. Nevertheless, the estate analogy has never found favor with the courts and commentators, whereas the entity analogy is in use in various considerations of corporate attributes.

Effect of Dissolution upon Executory and Executed Contracts

The attitude of the courts in a number of the cases is that there is a difference with regard to executory corporate contracts between the results of forced and voluntary dissolution.[68] They are more lenient with the sanctity of contract rights of a corporation which has been forced into involuntary dissolution, and accordingly hold that by such an event its obligations on executory contracts are discharged. The reasoning is based upon the assumption that the possibility of involuntary dissolution constitutes an implied condition in a corporation's contracts.[69]

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poration through the operation of law as an administrator acquires the title to the personal property of his intestate. A corporate act alone can affect that result." *Id.* at 786.

[66]Detroit v. Detroit Citizens' Street R. R., 184 U. S. 368, 46 L. ed. 592, 22 Sup. Ct. 410 (1901).

[67]Greenwood v. Union Freight R. R., 105 U. S. 13, 26 L. ed. 961 (1881); Att'y Gen. v. Chicago & E. R. R., 112 Ill. 520 (1884); Green v. Lawrence Bridge Co., 22 Kan. 438 (1879); Rockwith v. State Road Bridge Co., 145 Mich. 455, 108 N. W. 785 (1906); Allison v. Hannibal & R. County Gravel Road Co., 138 Mo. 332, 39 S. W. 910 (1897); Erie & N. E. R. R. v. Casey. 26 Pa, 287 (1856).

[68]Tennis Bros. Co. v. Wetzel & T. R. R., 140 Fed. 193 (C. C. N. D. W. Va. 1905); Peoria Engraving Co. v. Streator Cold Storage Door Co., 266 N. W. 548 (Iowa 1936); People v. Globe Mut. Life Ins. Co., 91 N. Y. 174 (1883); Tiffin Glass Co. v. Stoehr, 54 Ohio St. 157, 43 N. E. 279 (1896); Bracken v. William, etc., College, 1 Call (5 Va.) 161 (1797); Griffith v. Blackwater Boom & L'br. Co., 46 W. Va. 56, 33 S. E. 125 (1904).

[69]People v. Globe Mut. Life Ins. Co., 91 N. Y. 174 (1883). *Cf.* basis for this decision, note 70, *infra.* It is doubtful whether it can stand on its own merits or on the soundness of the doctrine enunciated; and it is difficult to reconcile the basis for the decision with any reason adopted by the lower court which enjoined further performance of the contract.

It is submitted, however, that in an analogy of this kind there is a fundamental difference between personal and corporate obligations. While it is true that because of the personal element involved, many personal obligations under executory contracts are extinguished by the death of the obligor, that is not as a matter of logic true of the executory contracts of a corporate obligor. This readily appears by reference to the axiom that a corporation has no personality to lose by death. Assuming the correct rule to be that the common law theory of the effect of corporate dissolution is no longer of any effect in any other instance, why draw a distinction between corporate obligations existing under executed and executory contracts? In the common law cases construing the effect of dissolution no distinction is made between obligor and obligee contracts. The fulfillment of an executory contract is an act of winding up. The penalty of losing the right to collect debts due the corporation is offset by the relief of the corporation from the obligations of its indebtedness. So accepting this without further statutory modification, the penalty is often an asset. However, modern statutory provisions imposing a limited stockholder liability beyond the loss of the original investment probably indicates an intent to modify *pro tanto* the stringency of the common-law rule.[70]

This distinction is therefore specious. In either event, the dissolution occurs because of the breach by the corporation of the condition of periodic life read into the contract.[71] The argument that if the stockholders of a dissolved corporation desire to profit from the dissolution by rescinding corporate contracts, the corporation should be innocent with respect to the *vis major* which caused the dissolution is the nearest approach to equitable reasoning. Can a corporation any more than an ordinary person take advantage of a breach provoked by its own culpability?

To render nugatory by operation of law an executory contract upon dissolution of a corporation and deprive the parties of the unrealized benefits of the contract is as much impairing the obligation of that contract as was the common-law doctrine of extinguishment of all contractual rights. Which party to the contract should be charged with contracting with knowledge of the date of expiration of the corporate charter? To charge a party contracting with a

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[70]State Banking Co. v. Hinton, 172 S. E. 42 (Ga. 1933).

[71]Central Tr. Co. v. Chicago Auditorium Ass'n, 240 U. S. 581, 36 Sup. Ct. 412 (1915). *Contra*: Mumma v. Potomac Co., 8 Pet. 281, 8 L. ed. 945 (1834); People v. Globe Mut. Life Ins. Co., 91 N. Y. 174 (1883) (based, however, upon the fact that the state had enjoined further performance of the contract by either party). *Cf.* also James v. Second Russian Ins. Co., 239 N. Y. 248, 146 N. E. 369 (1925); Dougherty v. Equitable Life Assurance Society, 266 N. Y. 71, 193 N. E. 642 (1934). These two latter cases give the same effect to Soviet decrees nationalizing insurance companies.

corporation with such knowledge would be unwarrantable when the risk entailed can more virtuously be shifted to the corporation. Manifestly it must have contracted with more potential power over the continuance of its existence.

Human death is unavoidable; corporate death not nearly so. In fact, one of the universally accepted virtues of corporate organization is the possibility of perpetual life. Regardless of our recent economic experience, that corollary remains firmly entrenched in our economics and jurisprudence. Without doubt we will go on accepting it with the same faith as heretofore. Then if a valid reason exists in the case of executory contracts for creating this exception to our modern modification and interpretation of the common-law doctrine, does not good reason exist for accepting the common-law doctrine in entirety? And yet there is little legal compunction that liability on executory contracts is summarily discharged upon forced dissolution of the corporation.[72] Judicial disagreement on the question arises from conflicting ideas of expediency rather than from doubt as to legality. However, it is demonstrated by authority that the fact that the time for performance of a contract extends beyond the charter period of corporate existence does not invalidate the contract.[73] And in New Jersey the courts have suggested that obligees of a corporation rely upon the security of the trust fund for protection in case of corporate dissolution before performance of the contract.[74]

Impairment of Obligations of Contracts by Corporate Dissolution

Statutory provisions for dissolution of corporations do not violate constitutional prohibitions against the impairment of obligations of contracts[75] any more than does the death of a private person.[76] Adopting the theory of a statute of limitations, this would be true although the obligations on contracts do not survive against the corporate estate. The attitude of the courts on the constitutional question when involved in the case of a limited statu-

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[72]Griffith v. Blackwater Boom & L'br. Co., 46 W. Va. 56, 33 S. E. 125 (1904).

[73]Cook, Corporations (8th ed.) 2369.

[74]Rosenbaum v. U. S. Credit System Co., 61 N. J. L. 545, 40 Atl. 591 (1898).

The analysis of the purported difference between the effect of voluntary and involuntary dissolution on choses in action and executory contracts has not been broken down into the possible four divisions. The argument has been applied to the comparative effect of the two methods of dissolution on executory contracts only, where there is more justification for summary invalidation. If the reason for the distinction in the case of executory contracts is debatable, its fate when applied to choses in action is readily seen.

[75]Mumma v. Potomac Co., 8 Pet. 281, 8 L. ed. 945 (1834); Crossman v. Vivienda Water Co., 150 Cal. 575, 89 Pac. 335 (1907).

[76]2 Kent, Comm. *307, n. (b).

tory period for winding up is not indicated. But in view of the constitutionality of statutes of limitation, it is not open to much doubt that it would be the same where the equitable rule is displaced by a limited statutory period. Both statutes are accountable to constitutional provisions. Time limit in a statute of limitations is a matter of legislative discretion.[77] So placed alongside a statute of limitations, the statutory period for winding up should be no more violative of constitutional restrictions.[78]

Is not the statutory period for winding up a statute of limitations?[79] What difference, other than in nomenclature, is there between the extinguishment of a property or contract right by this method and by other instances of the lapse of time? Time is the essence of the birth and death of many of our property and contract rights. Substantive rights are lost through the staleness of adjective law. Examples of such are innumerable. Property and contract rights are extinguished by the lapse of time in the administration of personal estates.

The Common-Law Doctrine in American Law

In spite of the great volume of judicial rule and *dictum* in the American cases disparaging the common-law doctrine of the effect of dissolution, some of our courts have actually applied the principle of extinguishment of the credit assets of defunct corporations upon the expiration of the statutory period for winding up. So it has been held that thereafter an action cannot be maintained by a corporation[80] or by a trustee for it;[81] that when the rights of creditors and stockholders have expired upon dissolution the legislature has no power to revive the corporation and authorize it to collect claims

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[77]Nadstanek v. Trask, 130 Ore. 669, 281 Pac. 840 (1929) (discretionary power of the legislature to enact statutes enumerating personal causes of action which shall survive held not in violation of constitutional provisions).

[78]The opinion in Crossman v. Vivienda Water Co., 150 Cal. 575, 89 Pac. 335 (1907), is worthy of detracting from the equitable rule of that jurisdiction which treats the surviving assets as a trust fund for the creditors and stockholders.

[79]*Contra*: Dukes v. Harrison & Reidy, 270 Ill. App. 372 (1933) (holding that it is not a statute of limitations, but merely a limitation of the power of a corporation to sue or be sued).

[80]Dundee Mortg. & Tr. Investment Co. v. Hughes, 77 Fed. 855 (C. C. Ore. 1896); Koekuk & H. Bridge Co. v. Wetzel, 228 Ill. 253, 81 N. E. 864 (1907); Central Stock & G. Co. v. Pine Tree L'br. Co., 140 Ill. App. 471 (1908); Ryan v. Vanlandingham, 7 Ind. 416 (1856); Bank v. Pattison, 28 Ind. 509; Hatfield v. Cummings, 140 Ind. 547 (1894); Att'y Gen. v. Fidelity L. & T. Co., 113 Iowa 439, 85 N. W. 638 (1901); Bowen v. Dorchester Ice Co., 255 Mass. 159, 150 N. E. 840 (1926); Bank of Miss. v. Duncan, 56 Miss. 166 (1878); Fox v. Horah, 36 N. C. 358, 36 Am. Dec. 48 (1841); Malloy v. Mallett, 59 N. C. 345 (1863); cases note 9, *supra*.

[81]Fisher v. U. S. Grant University, 115 Tenn. 238, 90 S. W. 294 (1905).

due it;[82] that a statute designed to revive debts extinguished under the common-law rule before enactment of the statute was unconstitutional;[83] that a plea denying plaintiff is a corporation is a plea in bar;[84] and that upon expiration debts due are extinguished.[85] Other cases have merely contained the language that the dissolution of a corporation becomes final for all purposes at the expiration of the statutory period of extended life;[86] and that abatement becomes absolute.[87] Neglect to bring the action within the liquidation period is a complete defense open to the corporation and stockholders alike.[88] Upon termination of the period allowed by statute for the settlement of its affairs the power of the corporation to dispose of its property ceases.[89] For similar reasons it has been held that the expiration of the statutory period for liquidation unaccompanied by extenuating circumstances is insufficient ground for the appointment of a receiver.[90]

One of the interesting cases on this question is *Dundee Mortgage & Trust Investment Company v. Hughes.*[91] In this case a federal court construed the Oregon statute extending the life of dissolved corporations to wind up their affairs,[92] and accordingly

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[82]Bank of Miss. v. Duncan, 56 Miss. 166 (1878).

[83]Commercial Bank v. Lockwood, 2 Harr. 8 (Del. 1835). Accord: Taggart v. Perkins, 73 Mich. 303, 41 N. W. 426 (1889); Rockwith v. State Road Bridge Co., 145 Mich. 455, 108 N. W. 785 (1906).

[84]Keokuk & H. Bridge Co. v. Wetzel, 228 Ill. 253, 81 N. E. 864 (1907).

[85]Ryan v. Vanlandingham, 7 Ind. 416 (1856); Coulter v. Robertson, 24 Miss. 278, 57 Am. Dec. 168 (1852). *Contra*: Citizens' Bank v. Jones, 117 Wis. 446, 94 N. W. 329 (1903) (mortgage owned by a corporate mortgagee did not become void upon the expiration of the three years).

[86]Bowen v. Dorchester Ice Co., 255 Mass. 159, 150 N. E. 840 (1926); Boston Tow Boat Co. v. Medford Nat. Bank, 288 Mass. 484, 117 N. E. 928 (1917). *Cf.* Central Stock & G. Co. v. Pine Tree L'br. Co., 140 Ill. App. 471 (1908), in which the court restricted its decision by adding that neither by construction nor by analogy should the limitation as to time given the corporation in which to settle up its affairs after dissolution be extended to include the rights of claimants which were not affected by dissolution.

[87]Ryan v. Vanlandingham, 7 Ind. 416 (1856); Conwell v. Pattison, 28 Ind. 509 (1867); Hatfield v. Cummings, 140 Ind. 547 (1894); Fox v. Horah, 36 N. C. 358, 36 Am. Dec. 48 (1841); Malloy v. Mallett, 59 N. C. 345 (1863); Von Glahn v. De Rossett, 81 N. C. 467 (1879).

[88]Standard Trust Co. v. Commercial Nat. Bank, 240 Fed. 303 (C. C. A. 4th, 1917).

[89]Sage v. Crowley, 83 Minn. 314, 86 N. W. 409 (1901). But *cf.* Peters v. National S. Co., 167 Wis. 131, 166 N. W. 43 (1918), holding that upon expiration of the period of prolonged corporate life contract rights held by the corporation and an individual as co-partners passed to the individual as the surviving partner.

[90]Watkins v. Nat. Bank, 51 Kan. 254, 32 Pac. 914 (1893); B. & O. R. R. v. Cannon, 72 Md. 493, 20 Atl. 123 (1890); Bowditch v. Jackson Co., 76 N. H. 351, 82 Atl. 1014 (1912); Newfoundland R. Const. Co. v. Schack, 40 N. J. Eq. 222, 1 Atl. 23 (1885).

[91]77 Fed. 855 (C. C. Ore. 1896).

[92]*Id.* at 856: "The statute of this state gives a bare extension of time . . . after dissolution of the corporation. Without the statute, as we have seen by the common law, all corporations were defunct from the moment of their dis-

held that since there was no provision in the statute allowing a defunct corporation to prosecute to a close an action commenced within the five years, the suit had abated.[93] In view of this pertinent reference to the common-law rule, when confronted by this case a stockholder claiming an equitable interest would hesitate to push his claim against a debtor of the corporation.

The cases adhering most persistently to the common-law rule, and which leave their final effect less to conjecture, are the Indiana cases. They hold that an answer alleging the charter of plaintiff corporation had expired and that no receiver had been appointed during the statutory period of prolonged life was not demurrable;[94] that the defense of dissolution of plaintiff corporation and the subsequent expiration of the statutory period of extended life as clearly constitute a bar to the action as the defense of the statute of limitations;[95] and that debts remaining due to a defunct corporation at the end of the statutory period of extended life are extinguished.[96]

Aside from these cases one of the strongest is *State of Iowa* ex rel. *Attorney General v. Fidelity Loan & Trust Company.*[97] A corporation, after entry of a decree of dissolution against it, appealed from that part of the decree appointing the receiver, but not from that ordering dissolution. All debts owing by and to it were extinguished and all actions by and against it abated. This may have been intended to conform to an Iowa statute which drew a distinction between the effect of voluntary and involuntary dissolution.[98] It provided that only a corporation whose charter had ex-

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solution. The statute extends their existence for a further period for a stated purpose. At the expiration of that period, it is the logic of the common-law rule that the corporation is as absolutely defunct as it would have been in the first instance had not its life been prolonged by the intervention of the statute."

[93]But *cf.* Dundee Mortg. & Tr. Investment Co. v. Hughes, 89 Fed. 182 (C. C. Ore. 1898), to the effect that since the five year statutory period had not expressly limited to the period actions already commenced at the time of dissolution, the action already commenced could be maintained indefinitely.

[94]Hatfield v. Cummings, 140 Ind. 547 (1894).

[95]Conwell v. Pattison, 28 Ind. 509 (1867).

[96]Ryan v. Vanlandingham, 7 Ind. 416 (1856). Conwell v. Pattison is the present Indiana authority on the question. By statute a period of two years is provided for winding up corporations dissolved voluntarily or by expiration of the charter period, but no such period is provided for corporations dissolved involuntarily.

[97]113 Iowa 439, 85 N. W. 638 (1901). Accord: Peoria Engraving Co. v. Streator Cold Storage Door Co., 266 N. W. 548 (1936).

[98]Clinton v. Coppedge, 2 F. Supp. 935 (1933); IOWA CODE (1931) §§ 8393, 12432, which first came into the Iowa laws as §§ 694 and 2166, respectively, IOWA CODE (1851). But *cf.* McCarthy Co. v. District Ct., 201 Iowa 912, 208 N. W. 505 (1926), holding that it is the prerogative of a court of equity, upon good cause shown, to set up a corporate receivership during the statutory period for liquidation.

pired by limitation or the voluntary act of the stockholders could continue for the purpose of winding up its affairs.

In North Carolina where the question has been given some prominence the courts have oscillated somewhat on it, starting out with the common-law rule in *Fox v. Horah*[99] and *Malloy v. Mallet.*[100] Although later the court attempted to modify that doctrine in *Von Glahn v. de Rossett*[101] to suggest the justice of the equitable doctrines, it went ahead and applied the common-law rule. Consequently it was held that where a statute continues the life of a corporation for a limited period the statutory remedy to a creditor of the corporation is exclusive, and if it is not pursued within the period, equitable jurisdiction of the court is unavailable. *Fox v. Horah* has also been partially overruled by a decision abolishing reverter of real property and escheat of personal property.[102]

Is Any Relief Available After Expiration of the Statutory Period?

The determinative question then confronts us: Are remedies to the corporation supplied by statutes for post-dissolution winding-

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[99]36 N. C. 358, 36 Am. Dec. 48 (1841).
[100]59 N. C. 345 (1863).
[101]81 N. C. 467 (1879).
[102]Wilson v. Leary, 120 N. C. 90, 26 S. E. 630 (1897).

The interest of the question of escheat may be pursued further in *In re* Hull Copper Co., 50 P. (2d) 560 (Ariz. 1935). The trustees of a dissolved corporation were unable to find the whereabouts of certain stockholders. In resolving the question whether the interests of these unknown stockholders should escheat to the state or be distributed to the known stockholders, the court held that these funds should be kept intact until the true owners appear. In California the trustees of a dissolved corporation deposit the distributive shares of unknown shareholders with the state for a period of three years. Cal. Civ. Code (1933) § 403d. It is problematical, however, whether by interpretation the scope of such decision or statute could be extended to imply an intent to save from extinction the interests of unknown stockholders in uncollected choses in action.

The Mississippi court has committed itself to the common-law doctrine. The first expression on the subject was in Coulter v. Robertson, 24 Miss. 278, 57 Am. Dec. 168 (1852), and since the court adopted the common-law doctrine of destiny of choses in action upon dissolution, in 1857 the present code provisions on the subject were enacted. Miss. Code Ann. (1930) §§ 4171, 4172. These provisions, however, were omitted from the code of 1871. During the period 1871-1880 when they were not a part of the code, Bank of Mississippi v. Duncan, 56 Miss. 166 (1878), came before the court. Having no precedent except that of Coulter v. Robertson, the court followed it, as a matter of precedent and because it was felt that under the circumstances the former adjudication had not been changed by statute but had actually been reiterated by the legislature. Then in 1880 the present provisions came back into the code at the behest of Justice J. A. P. Campbell who had rendered the decision in Bank of Mississippi v. Duncan, and they have since remained in abrogation of the common-law rule.

It should be noted that most of the American cases upholding the common-law rule were decided at an early period of our history. So a contrast of the economic utility of the corporate method of doing business then with the pres-

up periods exclusive? Numerical authority for a negative answer is contained in decisions where more general forms of the question have been adjudicated.[103] Fortunately, however, the Tennessee case was decided under legislative enactments providing both a concurrent directorate trusteeship and a prolonged period of corporate existence.[104] So it was held that the trustees could maintain the action after the end of the prolonged period.[105] In a declaratory opinion the New Hampshire court said that after the expiration of the period of prolonged life the stockholders could, by the exercise of corporate powers, divide the capital by agreement or legal process.[106] Clearly these cases are qualified more or less by the circumstances at issue. Aside from the Tennessee case, they hold definitely only that the *post-mortem* statutory period for action by the corporation does not preclude the exercise of jurisdiction by a court of equity over the general subject of liquidation.[107] For instance, in *Stewart v. Pierce* the stockholders were unable to act because of internal dissention. In this situation a court of equity has jurisdiction during the corporation's life.[108] The real ground for invoking the equitable remedy was that the legal remedy, although still alive, was unavailable.

Contrary to the somewhat unimpressive negation of these cases is *Von Glahn v. de Rossett.*[109] Although its authority is also *a priori,* it is the only decision approaching an affirmative answer. Here it was held that a creditor of the corporation was limited to the remedy of the statutory period.

In but few of these cases, however, in which the American conception of the common-law rule was developed, was there before the court the situation of the lapse of the statutory period without

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ent is indicative of the exigencies of commercial well-being, and suggestive of reasons of political economy for a change in the law.

[103]Stewart v. Pierce, 116 Iowa 733, 89 N. W. 234 (1902); Grand Rapids Tr. Co. v. Carpenter, 229 Mich. 582, 201 N. W. 882 (1925); School Dist. No. 3 v. Town of Greenfield, 64 N. H. 84, 6 Atl. 484 (1886); State v. State Bank of Tennessee, 5 Baxt. 101 (Tenn. 1875); Lindemann v. Rusk, 125 Wis. 210, 104 N. W. 119 (1905); Pabst v. Circuit Ct., 184 Wis. 301, 199 N. W. 213 (1924). *Contra*: Von Glahn v. de Rossett, 81 N. C. 467 (1879).

[104]*Cf.* Marshall v. Wittig, 215 Wis. 510, 238 N. W. 390, 392 (1931): "The directors, upon expiration of the statutory prolongation existence of a dissolved corporation, ceased to be the legal administrators of the corporation."

[105]This case is not in conflict with other Tennessee decisions. White v. Campbell, 5 Humph. 38 (Tenn. 1844); O'Connor v. Memphis, 6 Lea 732 (Tenn. 1881).

[106]Opinion of Justices, 66 N. H. 629, 33 Atl. 1076 (1891).

[107]Particularly: Stewart v. Pierce, 116 Iowa 733, 89 N. W. 234 (1902); Grand Rapids Tr. Co. v. Carpenter, 229 Mich. 582, 201 N. W. 882 (1925); Lindemann v. Rusk, 125 Wis. 210, 104 N. W. 119 (1905); Pabst v. Circuit Ct., 184 Wis. 301, 199 N. W. 213 (1924).

[108]Dupont v. Dupont, 251 Fed. 937 (Del. 1918); McCarthy Co. v. District Ct., 201 Iowa 912, 208 N. W. 505 (1926).

[109]81 N. C. 467 (1879).

any formal effort in the meantime by the corporation, or those interested in it, to preserve specific title to choses in action. We can apply the law of *Von Glahn v. de Rossett* by a compensating analogy. If the remedy of a *post-mortem* period of statutory life is not exclusive, what purpose does it serve? The utility of such a statute is more vague when it limits the post-dissolution period of *quasi*-corporate existence to a definite number of years, unless the remedy is exclusive of all interference by equity in the winding up process. That the courts lack power to enlarge the scope of the statute is clear upon reason and authority.[110] It may be that a choice between legal and equitable safeguards from extinguishment is available. But it has been held that the intent of the statutory period is to enable a corporation to liquidate without the intervention of a receiver, except where the legal protection fails.[111] And likewise that a corporation is not divested of title to its property during this period,[112] except when a receivership is provided by statute.[113] So if equitable jurisdiction continues after failure of expiration of the legal remedy and a transfer to equity is permissible, the statute is surplusage.[114]

Moreover, do not the decisions that the common-law rule takes effect upon expiration of the statutory period of extended life also enhance the argument that the statutory period is exclusive? Unfettered by statute, principles of equity are confined to no bounds of geographical jurisdiction. But on the other hand, strength is subtracted from the implication of these cases by the decisions that a court may appoint a receiver to continue with the administration beyond the statutory period of *quasi*-existence, provided the appointment is made before the lapse of the statutory period,[115] or application therefor is made within the period.[116]

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[110]Henderson v. Farmers' Savings Bank, 199 Iowa 496, 202 N. W. 259 (1925).

[111]McCarthy Co. v. District Ct., 201 Iowa 912, 208 N. W. 505 (1926).

[112]Olmstead v. Distilling & Cattle Feeding Co., 73 Fed. 44 (C. C. N. D. Ill. 1895); State v. Fogerty, 105 Iowa 36, 74 N. W. 754 (1898).

[113]St. Louis & S. Coal & Mining Co. v. Sandoval Coal & Mining Co., 111 Ill. 32 (1884).

[114]The length to which current statutes have gone to set up unlimited periods for liquidation suggests the wisdom of defining by statute the policy to be followed.

[115]Olmstead v. Distilling & Cattle Feeding Co., 73 Fed. 44 (C. C. N. D. Ill. 1895).

[116]Lime City B. & L. & S. Ass'n v. Black, 136 Ind. 544, 35 N. E. 829 (1893); Hatfield v. Cummings, 140 Ind. 547 (1894); Von Glahn v. De Rossett, 81 N. C. 467 (1879). *Contra*: Harned v. Beacon Hill R. E. Co., 9 Del. Ch. 411, 84 Atl. 229 (1912).

The Virginia statute [Va. Stat. (1936) §§ 3810, 3813], providing that directors may be appointed trustees of corporate assets upon expiration of the three-year period for liquidation, stands alone in the straightforward manner in which the question has been resolved. Ambiguous construction of such a statutory provision is unlikely.

Some Exceptions to Application of the Equitable Trust-Fund Doctrine

Some plausible exceptions detracting from the availability of the trust-fund doctrine grow out of two equitable principles. The first is that a receiver or trustee can take no rights which were extinguished before his appointment.[117] Akin thereto is the rule that survival of actions is a creature of statute.[118] An analysis of these principles for their application takes us back to the question whether the statutory remedy is exclusive. If it is, and a receiver is not appointed until after the expiration thereof, the right has been extinguished. This dovetails with the reason of the New York decision in which it was held that a cause of action cannot be created in favor of a corporation which had been dissolved prior to the existence of the cause of action.[119] The saving rule would be that the equitable remedy is concurrent with the statutory remedy, as implied from *Stearns Coal & Lbr. Co. v. Van Winkle.*[120]

The second equitable principle forming a possible judicial barrier to application of the trust-fund doctrine is that when a person has suffered the loss of an adequate legal remedy, through any cause except fraud, accident or mistake of fact, equity will grant him no relief.[121] The neglect of directors or stockholders to save their rights during the statutory period is a mistake of law.[122] We are not unmindful of the rule that equity provides a remedy where there is no plain, speedy or adequate remedy at law. But this initiatory conception of equity does not comprehend the lapse, through mistake of law, of the legal remedy for want of prosecution or assignment before dissolution or before the end of the administrative period set up especially to relieve from the effect of abrupt dissolution.

So it is clear that the design of the statutory period of prolonged *quasi*-corporate life is to preserve, for a limited time, adjective law for the relief of the dissolved corporation in its own right. This is axiomatic, although to go further into the contro-

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[117]Fitch v. Wetherbee, 110 Ill. 475 (1884); Morrison v. Savage, 56 Md. 142 (1880); Vorenberg v. American House Hotel Co., 246 Mass. 108, 140 N. E. 297 (1923); Prentiss v. Nichols, 100 N. Y. 227, 3 N. E. 81 (1885); Little v. Fleishman, 177 N. C. 21, 98 S. E. 455 (1919).

[118]Parks Shellac Co. v. Jones, 265 Mass. 108, 163 N. E. 883 (1928).

[119]Kinney v. Reid Ice Cream Co., 57 App. Div. 206, 68 N. Y. Supp. 325 (Sup. Ct. 1901).

[120]221 Fed. 590 (C. C. A. 6th, 1915).

[121]Murray v. United States, 46 Ct. Cl. 94; Beveridge v. Hewitt, 8 Ill. App. 467 (1881); Walker v. Kretsinger, 48 Ill. 502 (1868); Klinesmith v. Van Bramer, 104 Ill. App. 384 (1902).

[122]Accord: Kressler v. Ensley Co., 123 Fed. 546 (C. C. N. D. Ala. 1903): "It is clear upon principle in such a case that stockholders cannot maintain the suit if the corporation itself is not in a position to do so."

versial aspects of its employment alongside adequate equitable protection results in speculation. Nevertheless, a further speculative analysis of the compromise as to the functional positions of remedial law and equity throws some light on the question. The rationale is that thereafter the stockholders must go into equity and prove their ownership of assets of the defunct corporation. This is the function of equity. Once their rights have been established in chancery, the stockholders are remitted back to legal remedies against debtors of the defunct corporation. Thus is outlined a logical functional procedure, but formalistic to the extreme.

In any event, the credit assets of the dissolved but unadministered corporation are jeopardized. The unsettled and inarticulate conflict in many jurisdictions between the common-law rule and the equitable doctrines, even in its most charitable implications, hints at the existence of dangerous ground. If this is a correct interpretation of the scope of the equitable doctrines and the procedure necessary to invoke them, to the small firm now sometime removed from the expiration of the statutory period of prolonged corporate life and facing a bar by the statute of limitations, the expensive litigious and administrative procedure suggests no less an impairment of credit assets.[123] It does provide a saving procedure. But is not the price economic inexpediency? While a concept of abstract logic should not malign the efficacy of wise public policy and sound economic utility, that public policy, its application being obscured by historical precedents of the common-law, must have its establishment in positive enactments and its expression in unequivocal terms.[124]

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[123]The receiver of a dissolved corporation, acting under the most liberal statutes, is faced with the dilemma of unduly prolonging liquidation on account of the artifice of recalcitrant debtors, or closing the liquidation and risking extinguishment of uncollected debts.

[124]Since the purpose of this discussion is to direct consideration to discrepancies in the theories underlying the unsettled state of the law, no remedial ideas have been in mind, except the trend of current code provisions. However, while the procedural remedy of appointment of a receiver upon dissolution is apparent, that does not answer the actual question commonly confronted and discussed herein. Neither has it been the intention to engage in the herculean task of analyzing the decisions of each particular jurisdiction; but only to discuss the typical rules as they are embodied in the statutes and decisions of diversified code and common-law states.

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STATE BAR SECTION

Announcement of the Thirty-second Annual Meeting of the Mississippi State Bar

The Thirty-second Annual Meeting of the Mississippi State Bar will be held in Meridian, Mississippi, on June 16, 17 and 18, 1937, with headquarters at the Lamar Hotel.

The State Bar Commissioners will meet on Wednesday, June 16.

The Junior Bar Section will convene in separate meeting on Wednesday evening, June 16, at 8:00 o'clock.

The Bar Meeting proper will convene on Thursday morning, June 17.

The principal address will be delivered by Dean H. W. Arant, Secretary of the Association of American Law Schools, College of Law, Ohio State University, Columbus, Ohio.

Let's Go to Work

It is hoped that the above title is enough to make the reader pause a little and possibly read this article. The writer claims no particular literary ability but happens to be the one through whom an announcement, which may mean a great deal to the lawyers of the State, is made. It concerns the annual meeting of the Junior Bar, a state wide organization that embraces all the members of the Bar within the State of Mississippi, under the age of thirty-six years.

The Executive Committee, composed of Harvey Lee Morrison of Okolona, Chas. A. Sisson of Clarksdale, L. G. Fant, Jr. of Holly Springs, William A. Bacon of Durant, L. O. Smith, Jr. of Jackson, John C. Satterfield of Jackson, W. W. Dent of Collins, Jack Deavours of Laurel, J. K. Travis of Hattiesburg and J. H. Graham of Meridian, met in Jackson at the call of the Chairman, as required by the Resolution of the State Bar creating the Junior Bar, and completed plans for the annual meeting to be held in Meridian on June 16th.

It was decided to have the Junior Bar meeting on Wednesday night, the 16th, which is the night before the State Bar holds its annual convention. By this arrangement, members of the Junior Bar can participate in its session and not be deprived of any opportunity to attend the meetings of the State Bar.

The time of the meeting on Wednesday night is eight o'clock and every effort will be made to start and stop on time. Following the session that evening, some kind of entertainment will be held for those attending, possibly a dance. This is being left with the Meridian Bar.

The Executive Committee realized that, since this was the first regular meeting of the Junior Bar and the session that would start it on its way, the matters or topics brought before it should be of interest and concern to all of the younger members of the profession. Accordingly, some time was spent in selecting the subjects to be submitted for consideration.

It was and is the idea of the Executive Committee that the Junior Bar can take definite steps on the subjects to be discussed that will materially aid all of the members of this group; that we should so shape our program that we can, by proper committees, approach the 1938 session of the Mississippi Legislature with certain proposed legislative acts and seek to get them written into law.

The first subject on the program is "Encroachment on the Legal Profession" and is sub-divided into two topics. The first of these deals with corporate fiduciaries and the second with unauthorized practice of law by court clerks, justices of the peace, etc.

The second subject deals with the proposition of seeking appropriate legislation to provide for the poorer or less populated counties some form of county court, meeting monthly, thereby giving litigants a forum for settling their disputes without having to wait for more or less regular terms of the Circuit Courts and also causing an increase in the practice of law in these counties. It was suggested that, possibly, several counties could form a district and each bear its proportionate part of the expense of such a tribunal.

Seeking to have the discussion led in proper channels and to arrive at some goal, the Executive Committee authorized and directed its Chairman to select a committee of three to lead the discussion of each of the above three topics.

At this time, all of these committeemen have not been appointed and their acceptances received but the chairmen of these committees of three are as follows: John C. Satterfield will head the committee leading the discussion as to corporate fiduciaries, Charles A. Sisson will head the committee dealing with the county courts and J. K. Travis will head the committee dealing with unauthorized law practice.

At the meeting in Meridian, thirty minutes will be given for the consideration of each of these three topics, fifteen minutes of which will be allotted to the committee leading that particular discussion. There will be, however, ample time allowed for those who wish to discuss any one of these three matters.

At the conclusion of the consideration of the above matters, the election of officers for the ensuing year will be held and the

meeting will be adjourned for the social occasion immediately following.

From the above, it can be readily seen that great plans have been made for this June meeting. It is hoped that it will accomplish great results.

Frequently, the statement is made that the State Bar meetings are largely social gatherings where one sees old friends, renews acquaintances and makes new ones and a good time is had by all, but where nothing is "definitely" done. This comment has, for the most part, come from the younger members of the profession who are anxious to get things going.

This feeling was partly responsible for the creation of the Junior Bar because many young lawyers wanted things done to help them materially and to have more take place at the meetings than the reading of scholarly treatises, however interesting that might be.

The chance to accomplish something definite and certain is now before us. If the members of the Junior Bar are really concerned about trying to help ourselves and bring about a better condition in the Bar as a whole, the opportunity is ours. We have the organization, we are meeting in a place centrally located, the 1938 session of the Legislature is just around the corner, and the program of the June meeting is given in plenty of time to allow proper thought in its consideration.

It is the hope and desire of those who have planned this program and worked to create the Junior Bar that the June meeting will be well attended, that we will have definite ideas about these matters, that appropriate action will be taken and that the Junior Bar will begin to be a means of service to the men who compose it.

The chance is ours, what are we going to do about it?

Hugh N. Clayton,
Chairman, Junior Bar Section

NOTES

Contract Relations of the Infant in Mississippi—Estoppel and Ratification*

III. Estoppel

Over-solicitous in protecting the infant, the majority of courts still hold that, even though his appearance is that of maturity, his fraudulent acts or representations as to age will not estop him from pleading his disability in an action at law involving the contract thereby induced, and this is the rule when the minor is either prosecuting the suit[1] or is being sued.[2] On the other hand, when the action is in equity, it is generally stated that an infant can secure neither affirmative[3] nor defensive[4] relief from a contract which he has fraudulently induced.

(A) In Equity

The application of the doctrine of estoppel of an infant in equity was well considered by the Supreme Court of Mississippi in *Ferguson v. Bobo*,[5] in which a nineteen-year-old girl fraudulently conveyed land to her father to enable him to borrow, and he conveyed to the mortgagee. The *quondam* infant later brought eject-

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*This note, completing a discussion of infants' contracts in Mississippi, is a sequel to one in (1936) 9 Miss. L. J. 217, which dealt with disaffirmance of contracts and liability for necessaries.

[1]Myers v. Hurley Motor Co., 273 U. S. 18 (1927); Burdett v. Williams, 30 Fed. 697 (Conn. 1887); Ark. Reo Motor Car Co. v. Goodlett, 163 Ark. 35, 258 S. W. 975 (1924); Creer v. Active Auto Exch., 99 Conn. 266. 121 Atl. 888 (1923); Wieland v. Cobick, 110 Ill. 16, 51 Am. Rep. 676 (1884); Raymond v. Gen. Motorcycle Co., 230 Mass. 54, 119 N. E. 359 (1918); Sternlief v. Nat. Securities Corp., 263 N. Y. 245, 188 N. E. 726 (1934). *Contra*: Irwin v. Morell, 1 Dud. 72 (Ga. 1831); La Rosa v. Nichols, 92 N. J. L. 375, 105 Atl. 201 (1918).

[2]Merriam v. Cunningham, 11 Cush. 40 (Mass. 1853); Sawyer Boot & Shoe Co. v. Braveman, 126 Me. 70, 136 Atl. 290 (1927); Greensboro Morris Plan Co. v. Palmer, 185 N. C. 109, 116 N. E. 261 (1923); Internat'l Textbook Co. v. Connelly, 206 N. Y. 188, 99 N E. 722 (1912); Beam v. McBrayer, 132 S. C. 72, 128 S. E. 34 (1925).

[3]Goff v. Murphy, 153 Ky. 634, 156 S. W. 95 (1913); Ryan v. Growney, 125 Mo. 474, 28 S. W. 189 (1894); Hayes v. Parker, 41 N. J. Eq. 630, 7 Atl. 511 (1886); Kilgore v. Jordan, 17 Tex. 341 (1856). *Contra*: Sims v. Everhardt, 102 U. S. 300 (1880); McCarthy-Greene Motor Co. v. McCluney, 219 Ala. 211, 121 So. 713 (1929); Alt v. Graff, 65 Minn. 191, 68 N. W. 9 (1896).

[4]Louis v. VanCleve, 302 Ill. 413, 134 N. E. 804 (1922); U. S. Investment Corp. v. Ulrickson, 84 Minn. 14, 86 N. W. 613 (1901); Pemberton Bldg. & Loan Ass'n v. Adams, 53 N. J. Eq. 258, 31 Atl. 280 (1895). *Contra*: Foreman v. Dickinson, 177 Ark. 121, 6 S. W. (2d) 829 (1928). For general treatments of the subject of estoppel of infants, see 1 Williston and Thompson, Contracts (2d ed. 1936) §§ 245, 246; 3 Page, Contracts (2d ed. 1920) §§ 1601, 1625; 1 Elliot, Contracts (1913) §§ 315-320; notes (1901) 57 L. R. A. 684; (1920) 6 A. L. R. 416; (1922) 18 A. L. R. 520; (1934) 90 A. L. R. 1441; (1926) 13 Va. L. Rev. 44.

[5]54 Miss. 121 (1876).

ment, and, in a bill by the purchaser, the chancery court enjoined her from asserting title, stating that "whenever an infant who has arrived at the years of discretion, by direct participation, or by silence, when she was called upon to speak, has entrapped a party, ignorant of his title or of his minority, into purchasing his property from another, he will be estopped in a court of chancery from setting up such title."[6] Although the decision was carefully limited to "cases of actual fraud and deceit . . . by virtue of some act or omission,"[7] the duties enforced by the estoppel of the infant were manifestly contractual in their nature.

The principles of *Ferguson v. Bobo* were more clearly defined six years later in *Brantley v. Wolf*,[8] in which a married infant sold and conveyed her land at a time when she believed the deed was valid because she was married. The vendee was ignorant of the vendor's minority. The court refused to enjoin the *quondam* infant's subsequent action of ejectment, stating that there was "no element of deceit or intentional wrong" here as in *Ferguson v. Bobo,* and, unless there is such, that the privilege of disaffirmance can not be abrogated. Hence a bill to enjoin the prosecution of an action of ejectment on the ground of estoppel by the plaintiff's conduct during infancy is insufficient if it fails to charge affirmatively fraudulent conduct on the infant's part and to state facts which reasonably could have had the effect of misleading the complainant.[9]

An infant is not precluded in equity from avoiding his contract from the mere fact that he did not disclose his minority at the time of the formation of the agreement, even though the other

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[6]Ferguson v. Bobo, 54 Miss. 121, 134 (1876); *cf.* Wilie v. Brooks, 45 Miss. 542 (1871) (minor heir held not estopped from asserting title after receiving distributive share of purchase money from ancestor's land, but court held purchase money received should be refunded by guardian, or should be made a charge upon the land); Parmele v. McGinty, 52 Miss. 475 (1876) (where guardian made a sale of property under a void decree of the court, and the ward upon maturity received purchase money, *quondam* infant's action held a confirmation of sale, and he is estopped to deny same); Handy v. Noonan, 51 Miss. 166 (1875); Gaines v. Kennedy, 53 Miss. 103 (1876); Kemp v. Pintard, 32 Miss. 324 (1856).

[7]Brantley v. Wolf, 60 Miss. 420, 430 (1882); Ferguson v. Bobo, 54 Miss. 121. 131 (1867). But *cf.* Markham v. Merrett, 7 How. (8 Miss.) 437 (1843) (infant *feme covert* not estopped by relinquishment of dower made during coverture).

[8]60 Miss. 420, 430 (1882): "Legal fraud cannot be predicated of . . . conduct by a minor where it has been unmarked with any element of deceit or intentional wrong, because the right of disaffirmance is a privilege which the law attaches to the condition of disability, and of this right all men are bound to take notice." Kilcrease v. Shelby, 23 Miss. 161 (1851).

[9]Demourelle v. Piazza, 77 Miss. 433, 27 So. 623 (1899).

party believed him to be an adult,[10] and, likewise, his voidable contract is not enforceable against him solely because he dealt or traded as an adult.[11] To effectuate the estoppel it must be shown that the adult party knew of and relied on the infant's misleading acts or statements.[12]

It is only an "active participation or silent acquiescence in an act designed and intended at the time to operate as a fraud upon another" that will justify the doctrine of estoppel by conduct.[13] The silence must have been under such circumstances that there was both a specific opportunity and a real or apparent duty to speak.[14] The adverse party must allege and prove not only the injurious conduct of the minor and that he was at that time "of years of discretion," but also that he knew and intended that his acts would deceive the other person.[15] A court of equity should naturally be hesitant in construing an estoppel; nevertheless, under *Ferguson v. Bobo* and its successors it would seem that a chancellor has considerable discretion in inferring from the infant's conduct the fraudulent intent necessary to preclude his plea of disability.[16]

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[10]Wilie v. Brooks, 45 Miss. 542 (1871); Brantley v. Wolf, 60 Miss. 420, 430, 432 (1882); 1 ELLIOT, CONTRACTS (1913) § 320; 1 *id.* § 315: "Passive concealment on the part of the infant does not, either directly or indirectly, defeat the right of the infant to avoid his agreement." See Cook v. Toumbs, 36 Miss. 685, 688 (1859) (infant not estopped by recitals in deed).

[11]Brantley v. Wolf, 60 Miss. 420 (1882); Sewell v. Sewell, 92 Ky. 500, 18 S. W. 162 (1892); Alvey v. Reed, 115 Ind. 148, 17 N. E. 265 (1888); 1 ELLIOT, CONTRACTS (1913) § 315; 1 WILLISTON AND THOMPSON, CONTRACTS (2d ed. 1936) § 245. But see Evans v. Morgan, 69 Miss. 328, 332, 12 So. 270 (1891): "Infancy . . . is a shield for protection and not a sword for attack . . . When property is bought by an infant upon credit, and, being sued for the price, he pleads infancy, the seller may recover at law the property, the title being revested in him by the result of the suit for the price."

[12]Ferguson v. Bobo, 54 Miss. 121 (1876); Demourelle v. Piazza, 77 Miss. 433, 27 So. 623 (1899); Commander v. Brazil, 88 Miss. 668, 41 So. 497 (1906); see Lake v. Perry, 85 Miss. 550, 49 So. 569 (1909) (where party dealing with infant knew that he was a minor, though appearing of age).

[13]Brantley v. Wolf, 60 Miss. 420, 430 (1882); Yeager v. Knight, 60 Miss. 730 (1882); see also Upshaw v. Gibson, 53 Miss. 341 (1876); Demourelle v. Piazza, 77 Miss. 433, 27 So. 623 (1899); Levy v. Gray, 56 Miss. 318 (1879); Quinn v. Moss, 12 Sm. & M. (2 Miss.) 365 (1849).

[14]Brantley v. Wolf, 60 Miss. 420 (1882); Ferguson v. Bobo, 54 Miss. 121 (1876); see also Yeager v. Knight, 60 Miss. 730, 732 (1883); Upshaw v. Gibson, 53 Miss. 341 (1876); Robb v. Halsey, 11 Sm. & M. (19 Miss.) 141 (1848); 10 R. C. L. 689, 693.

[15]Demourelle v. Piazza, 77 Miss. 433, 27 So. 623 (1899); Brantley v. Wolf, 60 Miss. 420 (1882); Ferguson v. Bobo, 54 Miss. 121 (1867).

[16]1 ELLIOT, CONTRACTS (1913) § 320: "Nevertheless equity will as a general rule regard the circumstances surrounding the transaction, the appearance of the minor, his intelligence, the character of his representation, the advantage he has gained by the fraudulent representation, and the disadvantage to which the person deceived has been put by him in determining whether he should be permitted to invoke successfully the plea of infancy." See Commander v.

It is manifest that the reason for an estoppel is even stronger when the infant has made an express misrepresentation of his age.[17] The problem was first presented in Mississippi in *Ostrander v. Quin*,[18] in which it was held that "the wilful misrepresentation of age [by an infant] by which money is had of another on a mortgage, and which deceives the lender, is a bar to an avoidance of it on the solicitation in equity of the borrower." However, the *ratio decidendi* was not clear in this case, since the decision might have been based on the ground that the minor used the money for necessaries.[19] Hence in *Commander v. Brazil*[20] the Supreme Court considered the question fully and stated that "when a minor has reached that stage of maturity which indicates that he is of full age, and enters into a contract falsely representing himself to be of age, and accepts the benefit of the contract, he will be estopped in equity to deny that he was not of age when the obligation is sought to be enforced against him."

(B) At Law

In actions at law the majority of tribunals state that the doctrine of estoppel *in pais* may not be used against an infant,[21] but a small number hold that it may if there have been misrepresentations as to age and the infant has derived a benefit therefrom.[22]

Brazil, 88 Miss. 668, 41 So. 497 (1906); *cf.* Shivers v. Simmons, 54 Miss. 520 (1877) (estoppel of *feme covert*).

[17]See Hall, *The Liability of an Infant Who Represents Himself of Age*, 8 YALE L. J. 235.

[18]84 Miss. 230, 36 So. 257 (1904); *cf.* Ferguson v. Bobo, 54 Miss. 121 (1876); Brantley v. Wolf, 60 Miss. 430 (1882); Wilie v. Brooks, 45 Miss. 542 (1871).

[19]Commander v. Brazil, 88 Miss. 668, 670, 41 So. 497, 498 (1906).

[20]88 Miss. 668, 673, 41 So. 497, 498 (1906); Strother v. Sou. States Co., 159 Ga. 330, 125 S. E. 786 (1924); Klinck v. Reeder, 107 Neb. 290, 185 N. W. 1000 (1921); Grauman Co. v. Krienetz, 142 Wis. 604, 126 N. W. 52 (1910). *Contra*: Tobin v. Spawn, 85 Ark. 554, 109 S. W. 535 (1908).

[21]1 WILLISTON AND THOMPSON, CONTRACTS (2d ed. 1936) § 245, footnote 4. Although not within the scope of this note, it should be observed that generally an infant may be held liable in tort for deceit in misrepresenting his age with a purpose of inducing another person to contract with him. 1 WILLISTON AND THOMPSON, CONTRACTS (2d ed. 1936) § 245. However, a vehement minority holds otherwise, arguing that the infant should not be held liable when the action in tort arises from the contract, since to do so would in effect deprive the infant of his privilege of disaffirmance. 3 PAGE, CONTRACTS (2d ed. 1920) § 1601. But of course the answer to that is that "the infant is not held liable on his contract either in form or substance if he is liable in deceit." 1 WILLISTON AND THOMPSON, CONTRACTS (2d ed. 1936) § 245. Miss. would probably permit the action in tort. See *dicta* in Yeager v. Knight, 60 Miss. 730, 732 (1883); Commander v. Brazil, 88 Miss. 668, 671, 41 So. 497, 498 (1906); Brantley v. Wolf, 60 Miss. 420, 430 (1882).

[22]GEORGIA: Hood v. Dureen, 33 Ga. App. 316, 125 S. E. 787 (1924); Irwin v. Morell, 1 Dud. 72 (Ga. 1831); Walters v. Arrington, 39 Ga. App. 275, 146 S. E. 773 (1929).

KENTUCKY: Damron v. Commonwealth, 110 Ky. 268, 61 S. W. 459 (1901); Looney v. Elkhorn Co., 195 Ky. 198, 242 S. W. 27 (1922); Burk v. Moore, 209

How would the Supreme Court of Mississippi rule on this point? Several *dicta* indicate that, if the question were squarely presented in a justifiable case, it would permit estoppel.

In 1876 in *Ferguson v. Bobo*[23] it was said that an infant guilty of defrauding another as to his age "will be estopped in a court of chancery from setting up such title. . . How long before this doctrine will be fully adopted by courts of law, as so many equitable principles have been, the future of our jurisprudence must determine." At the same term *Upshaw v. Gibson*[24] was decided, in which an infant married woman, who had acquiesced in the sale by her husband of her mule, brought replevin for the possession of the animal. The court refused to estop the plaintiff, since there had been no "positive fraud" committed, the infant not having misled the purchaser "by any act" of her own. Speaking *obiter*, it was said that the courts have "sometimes applied the principle of estoppel to infants to prevent . . . [unfair] results. While we may be willing, in a proper case, to follow the lead of these decisions, we have not been able to find a case" estopping the infant in law where there has been "mere silence or acquiescence."[25]

Thirty years later, in *Commander v. Brazil*,[26] an undivided court apparently repudiated any distinction between law and

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Ky. 30, 272 S. W. 39 (1925); Pinnacle Motor Co. v. Daugherty, 231 Ky. 626, 21 S. W. (2d) 1001 (1929).

NEBRASKA: Klinck v. Reeder, 107 Neb. 290, 185 N. W. 1000 (1921); Cobbey v. Buchanan, 48 Neb. 391, 67 N. W. 176 (1896).

NEW JERSEY: La Rosa v. Nichols, 91 N. J. L. 355, 103 Atl. 390 (1917), 92 N. J. L. 375, 105 Atl. 201 (1918); Feir v. Weir, 92 N. J. L. 610, 106 Atl. 402 (1919); Sonntag v. Heller, 97 N. J. L. 569, 117 Atl. 639 (1922) (infant not estopped unless he received benefit from contract); Sawicki v. Slahor, 11 N. J. L. 630, 167 Atl. 691 (1933) (infant defendant held estopped from pleading infancy in girl's suit for breach of promise to marry); Steelman v. Gilbert, 116 N. J. L. 593, 186 Atl. 48 (1936).

TENNESSEE: Tuck v. Payne, 159 Tenn. 192, 17 S. W. (2d) 8 (1929); Barham v. Turbeville, 1 Swan (31 Tenn.) 440, 57 Am. Dec. 782 (1852).

TEXAS: Harseim v. Cohen, 25 S. W. 977 (Tex. Civ. App. 1894); Kilgore v. Jordan, 17 Tex. 342 (1856); Carpenter v. Pridgen, 40 Tex. 32 (1875); see Keys v. Tarrant Bldg. & Loan Ass'n, 286 S. W. 593, 597 (Tex. Civ. App. 1926).

WISCONSIN: Grauman Co. v. Krinetz, 145 Wis. 604, 126 N. W. 50 (1910).

[23] 54 Miss. 121, 135 (1876); see also, Brantley v. Wolf, 60 Miss. 420, 431 (1882): "Not finding it necessary in Ferguson v. Bobo to take position on this question [estoppel *in pais* of infants] as applicable to courts of law . . ." etc.

[24] 53 Miss. 341 (1876).

[25] Upshaw v. Gibson, 53 Miss. 341, 344 (1876): "But there is a marked distinction between actual and positive fraud, committed by some equivocal act, and that inferred from mere silence or acquiescence. . . It does not appear that Humphreys was induced to buy the property, or that the person who trusted him on the faith of it was induced to do so, or was misled by an act of Mrs. Upshaw." See Wilie v. Brooks, 45 Miss. 542 (1871); Cook v. Toombs, 36 Miss. 685 (1859); Markham v. Merrett, 7 How. (8 Miss.) 437 (1843); Cason v. Hubbard, 38 Miss. 315 (1861).

[26] 88 Miss. 668, 41 So. 497 (1906).

equity, with reference to estoppel of infants because of fraudulent representations, when it said *obiter* that certain

> "authorities lay down the rule that he [the infant] may not be sued at law, but he may be sued in equity. But it matters not in what court the suit may be brought or what the form of the action. . . . If the property of a minor is to be subjected to the payment of a debt or damages thus created by him by his fraudulent misrepresentations, we fail to see what protection is given the minor by adhering to the distinctions of form attempted to be drawn by many of the earlier authorities. . . . We fail to understand how it could be made any easier on the minor [to hold him liable] . . . through an action in tort instead of on his contract, if the same results follow."[27]

No reported Mississippi cases have since considered this question.

To safeguard the infant's privilege of disaffirmance, the states which allow estoppel in an action at law require facts which present a case of actual and positive fraud, not merely inferred from silence or acquiescence. In addition, not only must the minor have had sufficient discretion and intelligence to enable him to comprehend the effect of his conduct,[28] but he must also have received some benefit from the contract which he fraudulently induced by his misrepresentation of age.[29]

There is no logical reason, however, for limiting the doctrine of estoppel in law to cases where there have been misrepresentations of age. If a minor is old enough to be liable for his torts and crimes, it would seem that, in a case in which he has committed any kind of "positive fraud" which induced another party to contract with him, he should be estopped, if the adult acted *bona fide* and was actually injured, to plead his disability to avoid the obligatons arising thereunder. On such reasoning it has been held that the infant will be estopped in law when he has perpetuated the fraud by his conduct as well as by a verbal misstatement.[30]

Under such limitations, it is submitted that Mississippi should apply the doctrine of estoppel *in pais* to infants in a court of law. As to adults, estoppel *in pais* is almost as fully available in law as in equity.[31] Why should infants, denying in law their fraudulently

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[27]*Id.* at 672, 41 So. at 498 (1906).

[28]Hood v. Dureen, 33 Ga. App. 316, 125 S. E. 787, 788 (1924).

[29]Sonntag v. Heller, 97 N. J. L. 569, 117 Atl. 639 (1922).

[30]Harseim v. Cohen, 25 S. W. 977 (Tex. Civ. App. 1894).

[31]BIGELOW, ESTOPPEL (6th ed. 1913) 604; Wefel v. Stillman, 151 Ala. 249, 44 So. 203, 209 (1907): "The only estoppels which are available in equity and not in law are such as depend on titles and relations not cognizable at law. Thus the law . . . does not recognize the rights of *cestuis que trust*, and will

procured contracts, be made an exception to the use therein of this device? The same criteria which determined that it is manifestly unjust not to enforce an infant's contract in equity should likewise be applied in law. The estoppel-mechanism is available. Both reason and respectable authority justify its use in proper cases.[32]

IV. Ratification

In 1857 the Mississippi Legislature, following Lord Tenderden's Act,[33] adopted and has since retained the following statute:

> "An action shall not be maintained whereby to charge any person upon any promise made after full age to pay any debt contracted during infancy, or upon any ratification after full age of any promise or contract made during infancy, unless such promise or ratification shall be made by some writing, signed by the person to be charged therewith."[34]

Inasmuch as there are no Mississippi cases interpreting and only one citing this statute,[35] this section will consider its effect as construed by other courts under similar requirements.[36]

Since an infant's contract is not void but voidable—that is, valid until avoided[37]—"ratification does not, strictly speaking,

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not allow the legal title to land to be overcome by matters in parol." Tracy v. Roberts, 88 Me. 310, 34 Atl. 68 (1896).

[32]Walker, Ch., in La Rosa v. Nichols, 92 N. J. L. 375, 105 Atl. 201, 203 (1918): "It seems anomalous indeed that youths of sufficient age and capacity, although less than twenty-one years old, may be convicted of crime, and be held liable for their torts, and yet not be liable on their contracts when apparently of sufficient capacity to make them, and when they procure their making by fraud."

[33]*Cf.* with the Miss. statutes the original Lord Tenterden's Act, Stat. 9 Geo. IV, c. 14, § 5 (1828): "No action shall be maintained whereby to charge any person upon any promise made after full age to pay any debt contracted during infancy, or upon any ratification after full age of any promise or simple contract made during infancy, unless such promise or ratification shall be made by some writing, signed by the party to be charged thereby."

[34]MISS. CODE ANN. (1930) § 3350.

[35]Edmunds v. Mister, 58 Miss. 765, 773 (1881). It is believed this case is of no value whatever today on the question of ratification, since it proceeded on the erroneous premise that the infant's contract was void until ratified. See note (1936) 9 MISS. L. J. 217, demonstrating that such agreements are today held valid until disaffirmed.

[36]For notes on such statutes see (1877) 25 Am. Rep. 30; (1890) 18 Am. St. Rep. 706. For able, general treatments of the subject of ratification, see 1 WILLISTON AND THOMPSON, CONTRACTS (2d ed. 1936) § 239; 1 ELLIOT, CONTRACTS (1913) §§ 321-329; 3 PAGE, CONTRACTS (2d ed. 1920) §§ 1602-1608; 14 R. C. L. 246-253; see also notes (1922) 17 A. L. R. 1341 (moral obligation as consideration when connected with promise during infancy); (1929) 58 A. L. R. 1372 (ratification by infant of partnership's contracts); (1929) 59 A. L. R. 281 (payment on contract as ratification).

[37]Note (1936) 9 MISS. L. J. 217. A ratification is valid even though made without knowledge of the fact that infancy is a defense. American Mortgage Co. v. Wright, 101 Ala. 658, 14 So. 399 (1893). However, if it is made in

create a right against the infant, but merely terminates the power which the law gives him of avoiding a bargain he made while under age."[38] Not being an independent contract, the ratification is held not to require any consideration in addition to that of the contract of infancy. It is said that the latter contract furnishes the consideration for the ratification,[39] and that the *quondam* infant has merely waived his power to disaffirm.[40]

Therefore, when the contract has been ratified, the ground of the action is not the ratification, but the original contract.[41] If the defendant pleads infancy, the ratification is in confession and avoidance thereof, and should be pleaded, in actions at law, in the replication.[42] Unless the allegations of the bill in equity reveal the defense thereto, "it is always good pleading to state only a good *prima facie* case and to leave matter of defense to be stated by the defendant."[43] Hence, in one case, a bill was filed to foreclose a mortgage, the defendant pleaded infancy, and the complainant thereupon set up a ratification by amending the bill.[44]

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ignorance of the facts of the transaction or of the fact that he was an infant when the contract was made, then the ratification is invalid. Tobey v. Wood, 123 Mass. 88, 25 Am. Rep. 27 (1876); Ridgeway v. Herbert, 150 Mo. 606, 51 S. W. 1040, 73 Am. St. Rep. 464 (1899).

[38]1 WILLISTON AND THOMPSON, CONTRACTS (2d ed. 1936) § 239. An infant's personal representatives may ratify his contract after his death. Jefford's Adm'r v. Ringgold, 6 Ala. 544 (1844); Shropshire v. Burns, 46 Ala. 108 (1871); Bozeman v. Browning, 31 Ark. 364 (1876).

[39]1 PAGE, CONTRACTS (2d ed. 1920) § 1603; 1 ELLIOT, CONTRACTS (1913) § 331.

[40]14 R. C. L. 246: A ratification is "the definite abandonment of the optional right to disaffirm."

[41]1 PAGE, CONTRACTS (2d ed. 1920) § 1603; 1 ELLIOT, CONTRACTS (1913) §§ 321, 331, 332. Illustrative of the confusion in theory is the following *dicta* in Edmunds v. Mister, 58 Miss. 765, 774 (1881): "It is an anomaly in pleading that the plaintiff declares upon the original contract, and to a plea of infancy replied the new promise, while all the authorities declare that the recovery is not upon the original contract, but upon the new promise." See criticism of this old doctrine in note (1890) 18 Am. St. Rep. 700.

[42]Ward v. Scherer, 96 Va. 318, 31 S. E. 518 (1898); Fant v. Cathhart, 8 Ala. 725 (1845); Fetrow v. Wiseman, 40 Ind. 148 (1872); West v. Penny, 16 Ala. 186 (1849); Hartley v. Wharton, 11 Ad. & El. 934 (Q. B. 1840); American Freehold Co. v. Dykes, 111 Ala. 178, 18 So. 292, 296 (1895); note (1890) 18 Am. St. Rep. 701: "Suit should be brought on the contract ratified, and if infancy is pleaded, the plaintiff should reply the confirmation." Stern v. Freeman, 4 Met. 309, 312 (Ky. 1863): "This results necessarily from the fact that the contract is voidable only, and not void. It is valid until disaffirmed . . . In such a case, the only effect of the ratification is to prevent the defendant from disaffirming the contract sued upon, which, being valid until disaffirmed, clearly forms the basis of recovery, the ratification forming matter of confession and avoidance to the plea of infancy." Hodges v. Hunt, 22 Barb. 150, 151 (N. Y. 1856).

[43]GRIFFITH, MISS. CHANCERY PRACTICE (1925) §§ 182, 183.

[44]Lanier v. Hill, 30 Ala. 111 (1857); Smith v. Vaughan, 78 Ala. 201 (1884); American Freehold Co. v. Dykes, 111 Ala. 178, 18 So. 292 (1895); see GRIFFITH, MISS. CHANCERY PRACTICE (1925) §§ 341, 369, 397.

Consider the above-quoted statute. By its terms it is operative only as to "an action . . . upon any promise . . . upon any ratification" of a contract or debt made during infancy. The type of action designated, evidently, is one upon any contract which has been ratified, since, as has been seen, the action is not on the ratification but on the contract.[45] For example, it has been held that the statute applies only when an action is brought *against a quondam* infant *upon a contract* made by him during minority, and that it does not apply when a ratification is set up *as a defense* to an action brought by the former infant to recover back the consideration.[46] Manifestly, its purpose is to protect the *quondam* infant when he is sued.[47] He needs no protection when he has received the consideration from the adult, used it, and sold it after maturity; hence he is deemed to have ratified the transaction by his acts, and cannot prevail when he sues to recover the consideration paid the other party.[48]

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[45]Carroll v. Durant Nat. Bank, 38 Okla. 267, 133 Pac. 179 (1913); Barnes v. American Soda Fountain Co., 32 Okla. 81, 121 Pac. 250 (1912); Whitman v. Allen, 123 Me. 1, 121 Atl. 160, 162, 36 A. L. R. 776 (1923): "This statute applies only in suits brought against an infant, where he is acting on the defensive." Observe unusual exceptions in ME. REV. STAT. (1930) c. 123, § 2: "No action shall be maintained on any contract made by a minor, unless he, or some person lawfully authorized, ratified it in writing after he arrived at the age of twenty-one years, except for necessaries or real estate of which he has received the title and retains the benefit." See also MO. STAT. ANN. (1931) § 297, p. 1859; Koerner v. Wilkerson, 96 Mo. App. 510, 70 S. W. 509 (1902); Ward v. Scherer, 96 Va. 318, 31 S. E. 518 (1898) (Virginia statute is almost a *verbatim* copy of Lord Tenterden's Act); Va.-Carolina Chemical Corp. v. Chandler 168 S. C. 425, 167 S. E. 663 (1933); Steele v. Poe, 79 S. C. 407, 60 S. E. 951 (1908); Beam v. McBrayer, 132 S. C. 72, 128 S. E. 34 (1925); Sams v. Friedman, 79 S. C. 398, 60 S. E. 953 (1908).

[46]Hilton v. Shepherd, 92 Me. 160, 44 Atl. 386 (1898): "The plaintiff claims that this statute applies, not only when an action is brought against one upon a contract made by him during infancy, but also when a ratification is set up as a defense to an action brought by him to recover the consideration. The common law doctrine relating to the liability of minors upon their contracts was designed for their protection, and it is clear to us that this statute was intended as an additional protection. If it be held that, by this statute, one who seeks to enforce a contract made by him when a minor must first ratify it in writing, it has little significance, for all he will need to do in any case is to reduce his ratification to writing before bringing suit. Thus the statute is no protection to him. On the other hand, if the other party to the contract seeks to enforce it against him, the statute is protection . . . Now, how is it in case the minor wishes to repudiate the contract and recover the consideration? Can it be said that a minor who has received the articles purchased by him, who has kept and used them after he becomes of age, and then has sold them, is not barred from recovering back the consideration simply because he has not ratified the contract in writing? We think not. The statute would thus become a sword instead of a shield." But see Lamkin v. Ledoux, 101 Me. 581, 64 Atl. 1048, 1049 (1906) (explaining and distinguishing Hilton v. Shepherd, *supra*).

[47]Hilton v. Shepherd, 92 Me. 160, 42 Atl. 387, 389 (1898).

[48]Hilton v. Shepherd, 92 Me. 160, 42 Atl. 387 (1898); Whitman v. Allen, 123 Me. 1, 121 Atl. 160, 36 A. L. R. 776 (1923); *cf.* West v. Prest, 96 N. J. L. 209, 119 Atl. 169 (1929) (written-ratification statute is of course not requi-

The written-ratification statute being applicable only to actions against persons on contracts made while minors, the common-law, ratification-by-conduct doctrine is relevant, where the facts warrant, to all actions brought by *quondam* infants to recover the consideration paid.[49] Under this latter theory ratification is a question of intention, and may be construed if the intention to affirm may be reasonably and clearly implied from the conduct or words of the party ratifying.[50]

When the acts considered have occurred after maturity, ratification by conduct, as defined in many cases, is frequently indistinguishable from estoppel.[51] Although inability of many courts to estop an infant in law might be one reason for the frequent hyperextension of the ratification-by-conduct doctrine, careless terminology is primarily responsible for the confusion. To eliminate it, courts should require a clear implication of a purpose to affirm the contract in order to construe a ratification.[52] Where the other party has merely been misled by the *quondam* infant's acts, the flexible estoppel-device should be used.

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site as regards necessaries); Neal v. Berry, 86 Me. 193, 29 Atl. 87 (1894); Thurston v. Gilmore, 40 Me. 378; see Kemp v. Pintard, 32 Miss. 328, 329 (1856) (as to ratification by *feme covert*); Mayer v. McLure, 36 Miss. 389, 403 (1858); Bird v. Swain, 79 Me. 529, 11 Atl. 421 (1887); Robinson v. Weeks, 56 Me. 102. But *cf.* Shivers v. Simmons, 54 Miss. 520 (1877).

[49]McKamy v. Cooper, 81 Ga. 679, 8 S. E. 312 (1888); Hilton v. Shepherd, 92 Me. 160, 42 Atl. 387 (1898); Whitman v. Allen, 123 Me. 1, 121 Atl. 160, 162, 36 A. L. R. 776 (1923): Since the statute does not apply where the infant acts on the offensive, "it therefore is beside the pending case and we may decide this cause upon general legal principles." *Cf.* Lathrop v. Doty, 82 Iowa, 272, 47 N. W. 1089 (1891); Buchanan v. Hubbard, 119 Ind. 187, 21 N. E. 538 (1889); Parmele v. McGinty, 52 Miss. 475, 485 (1876); 1 ELLIOT, CONTRACTS (1913 §§ 326, 327; 1 PAGE, CONTRACTS (2d ed. 1920) § 1605; Ward v. Ward, 143 Ky. 91, 136 S. W. 137 (1911); Darraugh v. Blackford, 84 Va. 509, 5 S. E. 542 (1888); Hobbs v. N. C. & St. L. Ry., 122 Ala. 602, 26 So. 139 (1899) see Ellis v. Alford, 64 Miss. 8, 12, 1 So. 155, 157 (1886); Allen v. Poole, 54 Miss. 323, 331 (1877). But *cf.* Lamkin v. Ledoux, 101 Me. 581, 64 Atl..1048, 8 L. R. A. (N. S.) 104 (1906); Sawyer Co. v. Braveman, 126 Me. 76, 136 Atl. 290 (1927); Barnes v. American Soda Fountain Co., 32 Okla. 81, 121 Pac. 250 (1912).

[50]3 PAGE, CONTRACTS (2d ed. 1920) § 1606.

[51]See Parmele v. McGinty, 52 Miss. 475, 484 (1876); Handy v. Noonan, 51 Miss. 166, 169 (1875); Robb v. Halsey, 11 Sm. & M. (19 Miss.) 141, 146 (1848); *cf.* 3 PAGE, CONTRACTS (2d ed. 1920) §§ 1606, 1607; Hilton v. Shepherd, 92 Me. 160, 42 Atl. 389 (1898); note (1890) 18 Am. St. Rep. 704: "It is possible . . . that a party who will be deemed to have ratified his contract, made during infancy, by his conduct after coming of full age, may have no distinct idea of ratification, but his conduct be nevertheless inconsistent with any other result, as where, after coming of age, he retains property purchased . . . , or uses it as his own, or sells it. In such a case, . . . it would make no difference whether he contemplated a ratification or not."

[52]Sawyer Boot & Shoe Co. v. Braveman, 126 Me. 70, 136 Atl. 290, 291 (1927): "Ratification . . . is simply the intentional recognition of some previous promise with the intention of rendering it binding." Watson v. Peebles, 102 Miss. 725, 59 So. 881 (1912) (mere silence not adequate).

A number of courts have adopted the so-called doctrine of "ratification by laches," in which a failure to disaffirm within a reasonable time after majority is construed as an affirmation of the contract.[53] Mississippi, however, does not follow this rule, but holds with the majority of tribunals that the infant has the entire period of the statute of limitations within which to disaffirm a conveyance of realty or personalty, and that a mere omission to act within that time can never operate as an affirmation thereof.[54]

What constitutes a sufficient writing to satisfy the requirements of the statute? Generally speaking, any written instrument, signed by the party to be charged, which, in the case of adults, would have amounted to an adoption of the act of a party acting as an agent, will amount to a ratification.[55] The *quondam* infant need not expressly ratify, but the words must import a recognition and a confirmation of the contract.[56] A ratification must of necessity always resolve itself into a question of intention.[57] However, the instrument should, on a fair construction thereof, refer to the contract averred to have been ratified and recognize it as a subsisting obligation.[58]

What conclusions may be drawn from the preceding examination of the status of infants' contracts in Mississippi? First of

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[53]Ferguson v. Houston, etc., R. R., 73 Tex. 344, 11 S. W. 347 (1889); Bigelow v. Kinney, 3 Vt. 353, 21 Am. Dec. 589 (1830); Bentley v. Greer, 100 Ga. 35, 27 S. E. 974 (1896); 1 ELLIOT, CONTRACTS (1913) § 329.

[54]Note (1936) 9 MISS. L. J. 220, and footnotes 16, 17, and 18 thereof; Watson v. Peebles, 102 Miss. 725, 734, 59 So. 881, 882 (1912); Brantley v. Wolf, 60 Miss. 427 (1882); Shipp v. McKee, 80 Miss. 741, 31 So. 197 (1902). But see Thompson v. Strickland, 52 Miss. 574, 578 (1876), and same case on subsequent appeal, Hudson v. Strickland, 58 Miss. 186 (1880).

[55]Ward v. Scherer, 96 Va. 318, 31 S. E. 518, 519 (1898); Harris v. Wall, 1 Ex. 122 (1847); Sawyer Boot and Shoe Co. v. Braveman, 126 Me. 70, 136 Atl. 290 (1927) (bankruptcy petition and schedule by defendant after reaching majority not ratification of contract under statute).

[56]Whitney v. Dutch, 14 Mass. 457, 7 Am. Dec. 229 (1816); Sawyer Boot & Shoe Co. v. Braveman, 126 Me. 70, 136 Atl. 290, 291 (1927); Thurlow v. Gilmore, 40 Me. 381; Ward v. Scherer, 96 Va. 318, 31 S. E. 518, 519 (1898); Steele v. Poe, 79 S. C. 407, 60 S. E. 951, 952 (1908); 1 ELLIOT, CONTRACTS (1913) § 323.

[57]Sawyer Boot and Shoe Co. v. Braveman, 126 Me. 70, 136 Atl. 290, 291 (1927); Durfee v. Abbott, 61 Mich. 471, 477, 28 N. W. 521, 523 (1886).

[58]Throwell v. Shenton, L. R. 8 Ch. D. 318 (1878); see Hartley v. Wharton, 11 Ad. & El. 934 (Q. B. 1840) (the writing held sufficient, even though it did not contain the name of the creditor, the amount due, or the date, and parol evidence allowed to explain the same); Mayer v. McLure, 36 Miss. 389 (1858) (mere acknowledgment is held inadequate); Hilton v. Shepherd, 92 Me. 160, 42 Atl. 387 (1898); Ward v. Scherer, 96 Va. 318, 31 S. E. 518 (1898): "No particular form of words is required to make a confirmation of a debt contracted by a person when an infant, after he attains his majority, but they must import an unequivocal recognition and confirmation of the previous engagement, though they need not amount to a direct promise to pay."

all, it should be remembered that, with the exception of the written-ratification statute, the usual rules of the common law are generally applicable and the power of disaffirmance remains unmodified. The court, however, has three devices which it may use in a meritorious case to hold the contract irrevocable.

(1) A few tribunals have expanded considerably in the last three decades the doctrine of necessaries. On the whole, nevertheless, it has failed notably to keep pace with the great body of quasi-contractual law. Mississippi remains yet in that majority which clings to an elementary idea of what constitutes a necessary.

(2) Estoppel *in pais* is the most flexible mechanism with which an infant's contract may be held binding. Chancery courts use it whenever it is deemed good policy and morals. Law courts, assigning as a primary reason that it has not been done before, generally refuse to apply it to infants. The fact that courts of law long ago usurped the doctrine of estoppel *in pais* as to adults is apparently overlooked. However, strong *dicta* in several Mississippi cases indicate that it may be applied, in a law court in this state, to an infant who has fraudulently procured a contract and gained some benefit therefrom.

(3) When a *quondam* infant is sued in Mississippi upon a contract made during minority and a ratificaton thereof is relied upon, the instrument is required by statute to be in writing. On the other hand, when he sues to recover his consideration and has used that which he received, the statute does not apply, and the defendant may show, if he can, a ratification by conduct, which is governed by the rules of the common law.

William N. Ethridge, Jr.

Lotteries—"Bank Night" Schemes

Schemes for the distribution of property by chance have been brought before the courts from a very early time. The latest of these to be challenged is known as "Bank Night."[1] Under this plan a registration book is set up at or near the theater in which anyone, without charge, may write his name and address opposite a number. On the advertised night, at a specific hour, one number is drawn from a receptacle containing the numbers opposite which names have been placed on the register. The number and name of

[1]The term "Bank Night" has been copyrighted by the Affiliated Enterprises, Inc., of Denver, Colo., which licenses theaters to use the scheme. The term has probably been applied by the public to schemes which may vary in slight particulars from the original plan, and some theaters have adopted the plan without becoming licensees. For cases involving protection of the trade name see Affiiliated Enterprises, Inc. v. Gruber, 86 F. (2d) 958 (C. C. A. 1st, 1936); Affiiliated Enterprises, Inc. v. Gantz, 86 F. (2d) 597 (C. C. A. 10th, 1936).

the person winning is announced from the stage, in the lobby and at the entrance of the theater. That person is required to present himself within a prescribed time. If the prize is not claimed, it is allowed to accumulate from week to week.

Although the word "lottery" has been given various definitions, it is quite generally recognized that there are three elements necessary to constitute a lottery: a prize, a chance, and the giving of a consideration for that chance.[2] There is no difficulty in bringing bank-night schemes within the scope of the first two requirements, but the question of whether there is present a sufficient consideration passing from the participants to the sponsor to constitute a lottery has been the subject of much recent litigation.

I

The term "consideration," in connection with lottery, has a different significance than does the same term in contract law. The distinction to be drawn is that in a lottery there must be something of value parted with in return for the chance, while in the ordinary contract the intrinsic value of the consideration is not a matter of legal concern.[3] The problem then is one of interpretation of "valuable consideration," and what the courts deem sufficiently valuable to form a consideration necessary to constitute a lottery. Somewhere between the extremes of gratuitous distribution of property by chance, and the distribution by chance of property for a valuable consideration, bank night schemes lie.

If the purchase of a ticket were required before a chance at the prize were given, bank night would present no difficulty. The courts are well in accord in holding schemes similar to bank night to be lotteries, where the purchase of a ticket is required before a

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[2]Yellow-Stone Kit v. State, 188 Ala. 196, 7 So. 338, 7 L. R. A. 599 (1889); People v. Cardas, 137 Cal. App. 788, 28 P. (2d) 99 (1933); Cross v. People, 18 Colo. 321, 32 Pac. 821 (1893); 38 C. J. 286, § 1.

[3]Post Publishing Co. v. Murray, 230 Fed. 773 (C. C. A. 1st, 1916); State v. Hundling, 220 Iowa 1369, 264 N. W. 608, 103 A. L. R. 861 (1936); Commonwealth v. Plissner, 4 N. E. (2d) 241 (Mass. 1936); People v. Shafer, 160 Misc. 174, 289 N. Y. Supp. 649 (N. Y. Co. Ct. 1936); People v. Mail and Express Co., 179 N. Y. Supp. 640 (Sp. Sess. 1919), *aff'd mem.* 192 App. Div. 903, 182 N. Y. Supp. 943 (1st Dept., 1920), 231 N. Y. 586, 132 N. E. 898 (1921); State v. Crescent Amusement Co., 95 S. W. (2d) 310 (Tenn. 1936); Griffith Amusement Co. v. Morgan, 98 S. W. (2d) 844 (Tex. Civ. App. 1936).

See especially Commonwealth v. Wall, 3 N. E. (2d) 28, 29-30 (Mass. 1936) where Justice Qua, in dealing with bank night, said, "One may give away his property by chance and if the winner pays no price, there is no lottery. 'Price' in this connection means something of value and not the formal cosideration sufficient to support a contract." *Contra*: Maughs v. Porter, 157 Va. 415, 161 S. E. 242 (1931), criticized in Note (1932) 18 VA. L. REV. 465; (1932) 80 U. PA. L. REV. 744; *cf.* State v. Fox Kansas Theatre Co., 63 P. (2d) 929 (Kan. 1936). Maughs v. Porter is also severely criticized in State v. Hundling, *supra.*

chance can be obtained.[4] They hold that the price paid for the ticket is a valuable consideration sufficient to constitute a lottery, and the fact that the same price is always paid to see a picture show is immaterial.

The courts approach the problem by considering the question of whether the plan is really a gratuitous distribution of property by chance. If they feel that there is not a gratuitous distribution of property, then they assume the other extreme, that a valuable consideration has been given for the chance to participate. So the question becomes one, not of whether participants parted with anything of value for the chance at the prize, but of whether participation is free, in the full sense of the word. Thus in schemes in the nature of bank night, where no purchase is required, the courts hold that if free participation is not an actuality, and if there were only a few free participants in comparison to the total number entering into the scheme, the element of valuable consideration is present.[5]

Most bank-night schemes operate essentially in the same manner. People are allowed to register free, and to enter the theater free of charge to claim the prize. The only variation seems to be the differences in the periods of time allotted within which the prize must be claimed. Although the majority holding is that such schemes are not lotteries, the problem is not a settled one,[6] and pre-

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[4]Sanchell v. Lewis Amusement Co., 171 So. 426 (La. 1936); Sproat-Temple Theatre Corp. v. Colonial Theatrical Enterprises, Inc., 276 Mich. 127, 267 N. W. 602 (1936); People v. Miller, 271 N. Y. 44, 2 N. E. (2d) 38 (1936); Society Theatre v. Seattle, 118 Wash. 258, 203 Pac. 21 (1922) (scheme ruled illegal without regard to consideration as violation of city ordinance prohibiting the sale or *disposal* of property by chance). For cases, not involving theatres, where schemes requiring purchase of some article held lotteries, see *infra* note 13.

[5]General Theatres, Inc. v. Metro-Goldwyn-Mayer Distributing Corp., 9 Fed. Supp. 546 (D. Colo. 1935) (of the 534,000 tickets distributed, 354,000 were given to patrons who paid admission, and 180,000 given away outside the theater to anyone); Glover v. Malloska, 238 Mich. 216, 213 N. W. 107, 52 A. L. R. (1927) (very few free chances distributed); Featherstone v. Independent Service Station Ass'n of Texas, 10 S. W. (2d) 124 (Tex. Civ. App. 1928) (only a few tickets were actually given to non-customers); State v. Danz, 140 Wash. 546, 250 Pac. 37 (1926) (no one asked for or received a chance without buying ticket for admission).

[6]*Holding bank night not a lottery*: State v. Hundling, 220 Iowa 1369, 264 N. W. 608, 103 A. L. R. 861 (1936); State v. Eames, 87 N. H. 477, 183 Atl. 591 (1936); People v. Shafer, 160 Misc. 174, 289 N. Y. Supp. 649 (N. Y. Co. Ct. 1936); State v. Crescent Amusement Co., 95 S. W. (2d) 310 (Tenn. 1936); Griffith Amusement Co. v. Morgan, 98 S. W. (2d) 844 (Tex. Civ. App. 1936); several unreported cases from the Federal District Courts and the lower courts of Arizona, Arkansas, Indiana, and Missouri in accord are collected in Thurmon, *"Bank Night" Is Legal* (1937) 51-69. This pamphlet is an opinion prepared by the General Counsel of the Affiliated Enterprises, Inc., Denver, Colo. The Attorney Generals of Mississippi and Missouri have rendered opinions (Jan. 19, 1937 and March 27, 1936, respectively) declaring that bank

sents the courts with a perplexing situation. Courts have expressly said that mere presence in the vicinity of the theater, or benefits accruing to the operator in the form of increased attendance and advertising advantages, all do not amount to a valuable consideration sufficient to constitute a lottery,[7] yet on the other hand they have distinguished between the situation where two and one-half minutes are allowed the winner to present himself and claim the prize, and where immediate presence is required in order to win.[8]

II

A review of the cases on bank night and schemes similar thereto will lead to the conclusion that the problem posed by the courts of whether there is a valuable consideration, approaches one of policy. The term "valuable consideration" may become a device employed by the courts in holding legal or illegal a scheme which they feel should or should not be permitted. And, although there are very few decisions frankly putting the problem on a policy

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night is illegal. The opinion of the Attorney General of Missouri is discussed in (1936) 22 WASH. U. L. Q. 126.

Holding bank night a lottery, or in the nature of a lottery: State v. Fox Kansas Theater Co., 62 P. (2d) 929 (Kan. 1936) (bank night plan held an illegal "policy" or "scheme of drawing in nature of a lottery"); Commonwealth v. Wall, 2 N. E. (2d) 28 (Mass. 1936) (bank night held lottery where winner was required to present himself *immediately* in order to claim the prize; court expressly distinguishes case from State v. Hundling, *supra*, where *definite* time limit of 2½ minutes was allowed, on basis that persons who bought tickets had the advantage of immediate presence and therefore people actually paid for the chance at the prize). *Cf.* also Affiliated Enterprises, Inc. v. Gantz, 86 F. (2d) 597 (C. C. A. 10th, 1936); Central States Theatre Corp. v. Patz, 11 F. Supp. 566 (S. D. Iowa, 1935); City of Wink v. Griffith Amusement Co., 100 S. W. (2d) 695 (Tex. 1936). The last three cases are suits in equity where court held bank night so akin to lottery that the "clean hands" doctrine would prevent a court of equity from protecting the scheme by injunction.

For a collection of notes on bank night see: (1936) 25 CALIF. L. REV. 112; (1937) 12 IND L. J. 234; (1937) 21 MINN L. REV. 215; (1936) 14 N. Y. U. L. Q. REV. 98; (1936) 16 ORE. L. REV. 97; (1936) 22 WASH. U. L. Q. 126.

[7]State v. Hundling, 220 Iowa 1369, 264 N. W. 608, 103 A. L. R. 861 (1936); Commonwealth v. Wall, 2 N. E. (2d) 28 (Mass. 1936); State v. Eames, 87 N. H. 477, 183 Atl. 591 (1936); People v. Shafer, 160 Misc. 174, 289 N. Y. Supp. 649 (N. Y. Co. Ct. 1936); Griffith Amusement Co. v. Morgan, 95 S. W. (2d) 844 (Tex. Civ. App. 1936). Accord, where case involved plan analogous to bank night: Yellow-Stone Kit v. State, 188 Ala. 196, 7 So. 338, 7 L. R. A. 599 (1889); People v. Cardas, 137 Cal. App. 788, 28 P. (2d) 99 (1933); Cross v. People, 18 Colo. 321, 32 Pac. 821 (1893); Commonwealth v. Plissner, 4 N. E. (2d) 241 (Mass. 1936); People v. Mail and Express Co., 179 N. Y. Supp. 640 (Sp. Sess. 1919); *aff'd mem.* 192 App. Div. 903, 182 N. Y. Supp. 943 (1st Dept. 1920); 231 N. Y. 586, 132 N. E. 898 (1921). *Contra*: Maughs v. Porter, 157 Va. 415, 161 S. E. 242 (1931); *cf.* State v. Fox Kansas Theater Co., 62 P. (2d) 929 (Kan. 1936).

[8]State v. Hundling, 220 Iowa 1369, 264 N. W. 608, 103 A. L. R. 861 (1936) (winner allowed 2½ minutes to claim prize; held not a lottery); Commonwealth v. Wall, 2 N. E. (2d) 28 (Mass. 1936) (winner required to present himself immediately to claim the prize; held a lottery).

basis, yet the presence of such factors has cast an influence on the final holding. There are distinct reasons of policy which may cause the court to view the scheme with disfavor and perhaps to call it illegal as a lottery. The most prominent and influential of these is the fact that the scheme leads to results which the court may deem morally undesirable.

In actual operation, many participants buy tickets, not so much for the purpose of seeing the particular motion picture offered, but also in order to be inside the theater, which they feel may improve their chance at winning the prize, and to observe the actual drawing. Naturally, only one person can win, and others get no return except a picture which they would not otherwise have paid to see. And, although no individual is reduced to poverty by expending the price of a ticket, yet the law does not favor any scheme which promotes expenditures of such nature. In the second place, the scheme would tend to appeal to the cupidity of the public, by engendering the "easy-money" idea, that an inordinately large return may be obtained from an inconsequential "investment." The prize often accumulates to a rather large sum, representing a temptation and allurement sufficient to attract even the more conservative people. There is developed in the place of thrift and economy, a spirit of gambling and speculation. The passion to engage in more orthodox and admittedly immoral forms of gaming is stimulated.[9]

The purpose of our statutes prohibiting lotteries seems to be the protection of the moral welfare of the people. Although the bank night scheme may not come within the precise terms of these enactments, yet the courts are likely to recognize the fact that they are craftily devised with the purpose of evasion prominently in mind.[10] Under such circumstances they are likely to consider the "spirit" rather than the letter of the statute.

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[9]"It capitalizes on the weakness of human nature and takes an unconscionable advantage of an inherent desire in most, if not all of us, to obtain 'a whole lot of something for a little bit of nothing.'" Opinion of Attorney General of Mississippi on Bank Night (Jan. 19, 1937). Here there was "a carefully planned scheme to appeal to the cupidity of the public and the spirit of gambling and speculation, carrying with it the attendant detrimental results which were intended to be prohibited by the statutes making gambling and lottery offenses, and at least the scheme is unfair and contrary to public policy." Central States Theatre Corp. v. Patz, 11 F. Supp. 566 (S. D. Iowa, 1935). See also State v. Fox Kansas Theater Co., 62 P. (2d) 929 (Kan. 1936); Affiliated Enterprises, Inc. v. Gantz, 86 F. (2d) 597 (C. C. A. 10th, 1936); City of Wink v. Griffith Amusement Co., 100 S. W. (2d) 695 (Tex. 1936).

[10]In State v. Fox Kansas Theater Co., 62 P. (2d) 929, 937, the court in holding bank night in the nature of a lottery, said, "Besides we cannot escape the impression from the intricate and complicated outline of the bank night plan that it is in effect a plan to evade the constitutional and statutory provisions of this state as to lotteries." *Cf.* Affiliated Enterprises, Inc. v. Gantz,

The second policy factor which may on occasion guide the courts in their decision is the idea that bank night schemes approach unfair advertising. This factor may not be of primary importance, yet it nevertheless may have real influence. It will be well first to consider what advertising advantages accrue to the theater owner from the employment of the scheme, and then determine just why such advantages may be unfair. There are at least three separate gains reaped by the theater owner: (1) A definite and substantial increase in attendance on bank night, resulting in increased receipts and profits; (2) cheap shows, pictures which cost the operator less than a show ordinarily good enough to attract such a large attendance, may be displayed; (3) the name of the theater becomes much more popular with the public, since it is circulated freely among persons as a place of "excitement and entertainment," a place where something "hot" is going on. This last advantage has a definite commercial value.

Why should it be considered that these advantages are unfairly obtained, and that advertising by such means is an undesirable form of competition? In the first place, the plan attracts trade without calling attention to the merit of the advertiser's product. As a substitute for good entertainment, the chance element is used. Second, it is directed to an instinct which is not favored as an object of commercial exploitation. Third, socially undesirable results may evolve from such a method of advertising. Large crowds are usually attracted, both inside and outside the theater, resulting in jammed sidewalks, congested traffic in the streets, and the creation of much noise and confusion."

The stress and importance placed on these policy factors in connection with bank night will certainly vary with the individual court. As already brought out, a review of the decisions will show that the judges, in most cases, thought the policy factors were outweighed by the practical operation of the scheme. But the decisions, both on bank night and other schemes, clearly indicate how a court may and does adopt a liberal or strict construction of the term "valuable consideration," according to the dictates of its own conscience.

The principle that there must be something of actual value given by participants in return for the chance, instead of benefits, either direct or indirect, accruing to the sponsor of the scheme, has

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86 F. (2d) 597 (C. C. A. 10th, 1936); Central States Theatre Corp. v. Patz, 11 F. Supp. 566 (S. D. Iowa, 1935); City of Wink v. Griffith Amusement Co., 100 S. W. (2d) 1065 (Tex. 1936).

"On bank night as a nuisance *cf.* City of Wink v. Griffith Amusement Co., 78 S. W. (2d) 1065 (Tex. Civ. App. 1935), *rev'd* 100 S. W. (2d) 695 (Tex. 1936).

become rather firmly established in the common-law rules governing lotteries.[12] Before bank night arose, the courts had little difficulty in applying this principle literally and yet reaching the desired results. It is only natural then, that the courts will be reluctant to break entirely away from an established legal concept, and place a different construction on a term already given a fairly definite legal meaning. However, courts have had no difficulty in broadening their interpretation of "valuable consideration" to cover situations where chances were given only with the purchase of some article,[13] and situations where they felt the scheme was merely camouflaged so that free participation was only a sham.[14] There is no doubt that policy was the motivating factor in bringing about this shift.

Whenever the courts feel that the various policy factors behind bank night becomes so strong as to make the scheme undesirable as a matter of public policy, there is little doubt that the term "valuable consideration" will be given a still broader meaning, and be interpreted as including benefits accruing to the operator as a result of participation, rather than actual loss of value by those participating.[15]

L. A. Wyatt
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[12]See *supra* note 7.

[13]United States v. Jefferson, 154 Fed. 299 (C. C. Ky. 1905); Davenport v. Ottawa, 54 Kan. 711, 39 Pac. 708, 45 Am. St. Rep. 303 (1895); State v. Powell, 212 N. W. 169, 170 Minn, 239 (1927); State v. Mumford, 72 Mo. 265, 39 Am. Rep. 532 (1881); Matta v. Katsoulas, 129 Wis. 212, 212 N. W. 261, 50 A. L. R. 291 (1927); see additional cases cited *supra* note 4. *Contra*: R. J. Williams Furniture Co. v. McComb Chamber of Commerce, 147 Miss. 649, 112 So. 579 (1927).

[14]See cases discussed *supra* note 5.

[15]It is noteworthy that the Attorney General of Mississippi in his opinion (Jan. 19, 1937) that bank night is a lottery, considers the problem solely as one of policy, and adopts the view "when the plan as a whole reveals the two elements above referred to (i. e. the giving of a prize, winner determined by chance) only slight evidence of consideration is required." *Cf.* also State v. Fox Kansas Theater Co., 62 P. (2d) 929 (Kan. 1936); Maughs v. Porter, 157 Va. 415, 161 S. E. 242 (1931).

RECENT DECISIONS

AIRPLANES—TRESPASS BY FLIGHT LESS THAN ONE HUNDRED FEET ABOVE LAND—ACQUISITION BY PRESCRIPTION OF EASEMENT FOR ROUTE OF FLIGHT.

Defendant operated a commercial air line and daily caused aircraft to fly over the plaintiff's land at altitudes less than 100 feet above the surface, although plaintiff had warned him that he considered this a trespass on his land. The defendant's planes followed one of two well-defined courses. Plaintiff asked for an injunction restraining the operation of the aircraft through the airspace over plaintiff's property, and damages for the trespass upon the airspace, contending that unless such injunction is granted, defendant will repeat the trespasses and "impose a servitude upon the plaintiff's utilization, use, occupancy, and enjoyment of the surface of their land to their irreparable injury." HELD: Injunction and damages denied. Plaintiff having failed to show any actual injury by the flights has failed to prove a trespass to his property. Use of the airspace is incapable of ripening into an easement. *Hinman* et al. *v. Pacific Air Transport*, 84 F. (2d) 755 (C. C. A. 9th, 1936).

The problem of ownership of the airspace is not a new one, but the advent of the airplane has given an entirely new aspect to the question. Until recent years the Latin maxim, *Cuius est solum, eius est usque ad caelum*,[1] formulated in the 16th century, served as a basis for cases holding that an invasion of the air above land without contact with it was a trespass.[2] The tendency of the modern courts is to qualify, in a large degree, this theory.[3]

One doctrine which has been advanced to adapt the *ad-caelum* theory to present conditions concedes that the landowner does own the space above his land to an indefinite height, but gives to the public a privilege of passage so long as there is no interference with the landowner's enjoyment of his property.[4] The *Restatement* has apparently accepted this view, allowing an action of trespass to lie for "unprivileged intrusion, . . . at whatever height above the surface."[5]

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[1]Co. LITT. *4a; Baten's Case, 99 Coke's Report 54 (b) (K. B. 1611); Fay v. Prentice, 1 C. B. 827 (C. P. 1845). See Jome, *Property in the Air as Affected by the Airplane and the Radio* (1928) 62 AM. L. REV. 887, 889-97.

[2]Hannabalson v. Sessions, 116 Iowa 457, 90 N. W. 93 (1902) (reaching an arm into the airspace above another's land); Whittaker v. Stangvick, 100 Minn. 386, 111 N. W. 295 (1907) (shooting over another's land); Crocker v. Manhattan Life Ins. Co., 61 App. Div. 226, 70 N. Y. Supp. 492 (1st Dept. 1901) (overhanging wall); Butler v. Frontier Telephone Co., 186 N. Y. 486, 79 N. E. 716, 11 L. R. A. (N. S.) 920 (1906) (wire strung over land).

[3]Swetland v. Curtiss Airports Corp., *et al.*, 55 F. (2d) 201 (C. C. A. 6th, 1932); Smith, *et al.* v. New England Aircraft Co., Inc., *et al.*, 270 Mass. 511, 170 N. E. 385, 390, 69 A. L. R. 300 (1930) (private ownership of airspace limited to "all reasonable heights above the underlying land"); Cory v. Physical Culture Hotel, 14 F. Supp. 977, 982 (W. D. N. Y., 1936), in which the court stated that the landowner had exclusive rights to as much of the space above the portion actually occupied and used by him as was necessarily incident to such occupation and use.

[4]Note (1919) 32 HARV. L. REV. 569, 591.

[5]RESTATEMENT, TORTS (1934) § 159, Comment *e*. An explanation of the term *privileged* is given in Comment *f*: "A temporary invasion of the airspace by the aircraft, for the purpose of travel through it or other legitimate purpose, if done in a reasonable manner, and at such a height as is in conformity with legislative requirements and does not interfere unreasonably with the possessor's enjoyment of the surface of the earth and the air space above it, is privileged."

It has been contended by some authorities that an action for trespass will lie only where there has been a touching of something attached to the soil,[6] while others have allowed action for trespass where there has been a "harmful invasion" of the lower stratum.[7]

In the principal case, the court based its decision on the theory of effective ownership. "We own so much of the space above the ground as we can occupy or make use of in connection with the enjoyment of our land. This right is not fixed. It varies with our varying needs and is co-extensive with them . . . The owner of land owns as much of the space above him as he uses, but only so long as he uses it. All that lies beyond belongs to the world."[8] The plaintiff was held not to have shown a use of the superjacent space, and hence the court refused to recognize any possession in him of that space. In the tentative draft of the *Restatement* this doctrine was considered and rejected, and it was suggested that "a possible difficulty exists here because of the height of the column of air owned by the possessor of the surface would necessarily vary with the use of the property."[9] The doctrine adopted by the final *Restatement*,[10] that flights which do not "interfere unreasonably with the possessor's enjoyment" are privileged, will by the interpretation of the word *unreasonably* permit the same variance in the height at which the aviator may legally travel, without being subject to the objection that the amount of space owned changes with the use.

It is particularly important that in this comparatively early period of air travel, the industry be allowed to progress as rapidly as it may, without being retarded by damage suits brought purely for profit; it is just as important that the rights of the landowner be upheld, and that he not be laid open to invasion by the inability of courts to look into the future.[11] Either of the two principal theories is sufficiently flexible to allow unhindered flights of aircraft, and, at the same time, to furnish a remedy for intrusions which are actually harmful to landowners. The doctrine adopted by the court in the principal case takes care of the problem very adequately; probably the *Restatement* view is the more acceptable one because of the strong feeling still held by the layman for the *ad-caelum* theory.[12]

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[6]See SALMOND, TORTS (7th ed. 1928) 238, where it is stated that any unreasonable impairment of the possessor's enjoyment of the surface by flight of aircraft through the air above the surface is a nuisance of which the possessor can complain.

[7]Swetland v. Curtiss Airports Corp., *et al.*, 55 F. (2d) 201 (C. C. A. 6th, 1932) (an action for nuisance as the remedy for flights in the upper stratum); POLLOCK, TORTS (13th ed. 1929) 362.

[8]84 F. (2d) 755, 758 (C. C. A. 9th, 1936).

[9]RESTATEMENT, TORTS (Tent. Draft No. 7) § 1002, n. 2: "If a tall building were erected on A's land, A certainly would own the column of air to the height of the building and for some little distance above. On the other hand, if the land were used to grow a crop, the column of air necessary to the possessor's enjoyment would naturally be very shallow."

[10]RESTATEMENT, TORTS (1934) § 159.

[11]Hine, *Home Versus Airplane* (1930) 16 A. B. A. J. 217.

[12]Essentially the same results were reached in Swetland v. Curtiss Airports Corp., *et al.*, 55 F. (2d) 201 (C. C. A. 6th, 1932) and Smith, *et al.* v. New England Aircraft Co., Inc., *et al.*, 270 Mass. 511, 170 N. E. 385, 69 A. L. R. 300 (1930). See (1932) 20 CALIF. L. REV. 666, (1930) 30 COL. L. REV. 579, (1930) 29 MICH. L. REV. 242, (1930) 78 U. PA. L. REV. 902. For general discussions of the matter see Thurston, *Trespass to Airspace* (1934) HARVARD LEGAL ESSAYS 501; Ball, *Vertical Extent of Ownership in Land* (1928) 76 U. PA. L. REV. 631.

On one point in the principal case, however, the court took an unique stand. In explaining why an injunction need not be grated to prevent the defendant from gaining an easement, the court stated, "If no air were present therein, appellees' planes could not navigate. The primary thing appellees are using would appear to be the air overlying appellant's land. It is generally held that an easement of or in the air may not be obtained by prescription."[13] But is the air the primary thing being used by the defendant? Is it not rather the air *space*? In *Portsmouth Co. v. United States*[14] it was held that the firing of a shell over another's land, with the intent to gain a prescriptive right, might secure such a right; yet a shell does not make use of the air for its passage, but, rather, is impeded by it. "The analogy between a battery, so located that it will discharge missiles over another's land, and an airport so located that the plane using it must frequently fly over the land of another at low elevations, is complete . . . [I]f he may not fire projectiles across another's property without infringing the property rights of the owner, he may not fly planes across it without infringing the same right."[15] Before the statement in the instant case the rule as to inability to acquire an easement in light and air by prescription had been applied solely to situations where the owner of one tenement claimed to have acquired an easement to light and air over the land of an adjoining tenement merely because he had been enjoying the light and air for a sufficient period of time.[16] This easement to light and air cannot be gained by prescription because the owner of the "servient" estate has no right of action against the owner of the "dominant" estate who is using the light or air, and would therefore be unable to prevent the running of the period.[17] But the owner may have a right of action in the case of the flight of an airplane over his land. An aviator who flies low over the land of another is making a definite affirmative encroachment which interferes with the landowner's enjoyment of his land and for which the owner has a remedy at law. The two situations are therefore not analogous in any sense of the word, and the court in the instant case has allowed the broad statement that an easement cannot be acquired by prescription in light and air to lead it into error.[18]

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[13]84 F. (2d) 755, 759 (C. C. A. 9th, 1936).

[14]260 U. S. 327, 43 S. Ct. 135, 67 L. ed. 287 (1922).

[15]Hine, *Home Versus Airplane* (1930) 16 A. B. A. J. 217, 218.

[16]Yuba Consolidated Goldfields v. Hilton, 16 Cal. App. 228, 116 Pac. 712 (1911); Keating v. Springer, 146 Ill. 481, 34 N. E. 805, 22 L. R. A. 544, 3 Am. St. Rep. 175 (1893); Case v. Minot, 158 Mass. 577, 33 N. E. 700 (1893).

[17]"The basis of a prescriptive right to an easement is adverse user, and in the nature of things there can be no adverse user of light or air, for the actual enjoyment of these elements by a property owner is upon his own land only, and involves no encroachment upon his neighbor's land, nor any interference with the latter's enjoyment of his own property to which he can object; and that the owner of the adjoining land, therefore, having submitted to no encroachment upon his own rights, cannot be presumed to have assented to any such encroachment." 19 C. J. 903, § 85 (2). See also Keats v. Hugo, 115 Mass. 204, 15 Am. Rep. 80 (1874); Bailey v. Gray, 53 S. C. 503, 31 S. E. 354 (1898).

In England, however, it was the established rule first by decision and then by statute, that the owner of a house or building might acquire by lapse of time a prescriptive easement to light from the adjacent land. Tapling v. Jones, 11 H. L. Cas. 290 (1865); Chastey v. Ackland [1895] 2 Ch. 389. But, for the reasons indicated in the preceding paragraph, the English courts have denied that a prescriptive right could be acquired to the wind needed to run a windmill. Webb v. Bird, 13 C. B. N. S. 841 (C. P. 1863).

[18]It can readily be seen that the extension of the light and air rule to airplanes is unjustifiable when we note that, carried to its logical conclusion, it

The court did not need to resort to the light-and-air doctrine, for it had already decided that the plaintiff had no right of action because he lacked possession of the airspace which the defendant was using. This meant that the defendant's flights were lawful and that he therefore did not need to claim acquisition of an easement by prescription. However, since the statement as to prescriptive right was pure dictum and obviously erroneous, it is not likely that it will affect future decisions on this point.

Elliott Raleigh Danzig

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would mean that a person flying airplanes one foot above the land of another, continuously for thirty or forty years, could not gain an easement, yet a person who walked across that land once a day for the same period might very easily be deemed by the court to have acquired an easement by prescription.

BOOK REVIEWS

JUSTICE OLIVER WENDELL HOLMES, HIS BOOK NOTICES AND UNCOLLECTED LETTERS AND PAPERS. Edited by Harry C. Shriver. New York: Central Book Company. 1936. Pp. xiii, 280. $3.00.

"How old is 91" might have been a more popular title for this little book, which completes the Miscellanea of the writings of the late Justice Oliver Wendell Holmes. The Saturday Evening Post uses that title, and quite appropriately in view of the current discussion of the age of Supreme Court justices, in a recent article[1] which consists of extracts, much condensed, from the letters which Holmes wrote to Dr. John H. C. Wu. These letters were first published by Dr. Wu in the October, 1935, issue of the T'ien Hsia Monthly. They were written during the last ten years of Holmes' membership on the Supreme Court, the last letter being written after Holmes was 91 and shortly before his death.

The book is arranged in three parts. The first consists of a collection of early book notices, written during the years 1870-1873 when Holmes was editor of the American Law Review. These notices were unsigned and first identified by Professor Felix Frankfurter. They range in interest from Roman Law and Jurisprudence to standard lawyers' texts in Bankruptcy, Procedure, Equity and Constitutional Law and include the first review of the first case-book, Langdell's Cases in Contracts, prepared for use as a text book in the Harvard Law School in 1870. In these days of discussion concerning the function of judicial review of legislation, the following quotation from a book notice written in 1872 under the title *Austin and the Nature of Law*, sounds quite modern: "It must be remembered, as is clear from numerous instances of judicial interpretation of statutes in England and of constitutions in this country, that in a civilized state it is not the will of the sovereign that makes lawyer's law, even when that is its source, but what a body of subjects, namely, the judges, by whom it is enforced *say* is his will. The judges have other motives for decision, outside their own arbitrary will, besides the commands of their sovereign. And whether those other motives are, or are not, equally compulsory, is immaterial, if they are sufficiently likely to prevail to afford a ground for prediction. The only question for the lawyer is, how will the judges act?"[2] This quotation, selected from many others equally significant, reveal, as Justice Stone says in his fitting introduction of the volume, "the germinal ideas which a generation later were to come to full power in the judicial opinions which have made Justice Holmes' name a symbol wherever law is the subject of study and reflection."

For the second part of the volume, there is a group of uncollected short speeches and papers, such as his first and only radio address on the occasion of his ninetieth birthday, and several unpublished letters, including his letter of resignation from the Supreme Court.

The third part consists of the letters to Dr. Wu, mentioned above. They are full of sympathetic understanding and wise counsel for the young Chinese scholar, but are not limited to his problems. They have an appeal to the universal audience of scholars. Like everything to which Holmes put his pen, these collected papers are written in his inimitable brilliant, yet simple, style.

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[1] SATURDAY EVENING POST (March 20, 1937). No mention is made of the present volume.

[2] Pp. 25-26. Compare the much-quoted statement of Chief Justice Hughes, "We are under the Constitution but the Constitution is what the judges say it is."

A word of praise must be added for the excellent editing of these interesting materials. Needed explanations and adequate references and footnotes are included, yet the volume is not over-documented. We are indeed fortunate to have such an able editor assemble and preserve these stimulating fragments of the great philosopher-judge.

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